Supreme Court, U.S.
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No. 00-

IN THE

Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

ERIC R. FOX
Counsel of Record
DIRK J.J. SURINGA
IVINS, PHILLIPS & BARKER
Attorneys for Petitioner
1700 Pennsylvania Avenue, N.W.
Washington, DC 20006
(202) 393-7600

160748

Counsel Press LLC
(800) 274-3321 • (800) 359-6859

94pp

QUESTION PRESENTED

Whether an affiliated group of corporations with a consolidated net operating loss attributable in part to product liability expenses may carry back those expenses for up to ten years as a "product liability loss" under section 172(j)(1) of the Internal Revenue Code of 1954 if the group members that incurred the product liability expenses had positive "separate taxable income" under Treasury Regulation § 1.1502-12.

CORPORATE DISCLOSURE STATEMENT

Petitioner, a publicly held corporation, has no parent, and no publicly held corporation owns 10% or more of its stock.

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United Dominion Industries, Inc., respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case, a judgment which directly conflicts with a substantially contemporaneous judgment by the United States Court of Appeals for the Sixth Circuit.

OPINIONS BELOW

The Fourth Circuit opinion (App. A) is reported at *United Dominion Indus., Inc. v. United States*, 208 F.3d 452 (4th Cir. 2000). The district court opinion (App. B) is reported at *United Dominion Indus., Inc. v. United States*, 98-2 U.S.T.C. (CCH) ¶ 50,527 (Jun. 9, 1998).

STATEMENT OF JURISDICTION

The judgment of the Fourth Circuit Court of Appeals was entered on March 24, 2000. The court of appeals entered an order denying a timely petition for rehearing and suggestion for rehearing en banc on May 19, 2000 (App. C).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves sections 172(b)(1)(I), 172(c), and 172(j)(1) of the Internal Revenue Code of 1954, and sections 1, 11, 12, 21, 75, and 79 of the consolidated return portion of the Treasury Regulations, § 1.1502, as in effect during the years 1983 through 1986. Because the Treasury Regulations are lengthy, they are set forth separately in *Appendix D*.

For the years in question, section 172(b)(1)(I) provides the following:

> (I) PRODUCT LIABILITY LOSSES. — In the case of a taxpayer which has a product liability loss (as defined in subsection (j)) for a taxable year beginning after September 30, 1979 (referred to in this subparagraph as the "loss year"), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the loss year.

Section 172(j)(1) defines the term "product liability loss" as follows:

> (1) PRODUCT LIABILITY LOSS. — The term "product liability loss" means, for any taxable year, the lesser of —
>
> > (A) the net operating loss for such year reduced by any portion thereof which is attributable to a foreign expropriation loss, or
> >
> > (B) the sum of the amounts allowable as deductions under sections 162 and 165 which are attributable to —
> >
> > > (i) product liability, or
> > >
> > > (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(c) defines the term "net operating loss," in pertinent part, as follows:

> (c) NET OPERATING LOSS DEFINED. — For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income.

STATEMENT OF THE CASE

1. When a taxpayer's deductions for a given year exceed its income for that year, the taxpayer for that year has a "net operating loss" for U.S. federal income tax purposes. Section 172 of the Code generally allows a taxpayer to carry back the amount of this net operating loss as an offset to income in any of the three years preceding the loss year. The main reason for this provision is to smooth the taxpayer's income and loss over multiple tax accounting periods.

For the years 1983 through 1986, section 172(b)(1)(I) of the Code allows a taxpayer to carry back the amount of any "product liability loss" for *ten* years, instead of three. The main reason for this extension is that the latent cost of product liability often takes years to emerge, rendering the three-year matching period insufficient. *See* Joint Comm. on Tax'n, 95th Cong., General Explanation of the Revenue Act of 1978, at 232 (Comm. Print 1979). The ten-year carryback has been a part of the federal income tax law since 1979. *See* Revenue Act of 1978, § 371, Pub. L. No. 95-600, 92 Stat. 2763, 2859 (1978).

In 1990, Congress reorganized section 172 and made the term "product liability loss" a subcategory of the term "specified liability loss" in section 172(b)(1)(C) and (f).

See Omnibus Budget Reconciliation Act of 1990, § 11811, Pub. L. No. 101-508, 104 Stat. 1388, 1388-530 (1990). This reorganization did not change the meaning of the term "product liability loss" and simply brought under one subsection all types of expenses entitled to the ten-year carryback. This statute remains in effect to date. *See* I.R.C. § 172(b)(1)(C) & (f) (2000).

Mechanically speaking, a taxpayer's product liability loss or its specified liability loss is the amount of its deductible product liability or specified liability expenses for a given year, limited to the amount of the taxpayer's net operating loss for that year. Thus, for example, if the taxpayer has a net operating loss of $100 and product liability expenses of $80 for a given year, then the taxpayer has a product liability loss of $80. If the taxpayer has no net operating loss for a year, its product liability loss for the year is zero, regardless of whether the taxpayer incurred qualifying expenses in that year. The identical mechanism applies to specified liability losses.

2. This case concerns how the ten-year carryback regime described above applies to affiliated groups of corporations electing to file consolidated federal income tax returns under section 1501 of the Code. Subject to certain exceptions, an affiliated group filing consolidated returns is taxed as if it were a single corporate taxpayer filing a single federal corporate income tax return. The extensive Treasury regulations found under section 1502 and related provisions of the Code generally spell out the tax treatment of such affiliated groups.

Under the consolidated return regulations, an affiliated group calculates its taxable income or net operating loss in a

multi-step process. One early step in this process requires the calculation of each individual group member's "separate taxable income." Under the regulations, a member's separate taxable income is "computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations," subject, however, to several modifications. *See* Treas. Reg. § 1.1502-12 (App. D, at 46a). In broad terms, an affiliated group's consolidated taxable income or net operating loss represents the sum of the positive and negative separate taxable incomes of all group members, subject to numerous, carefully defined modifications. *See generally* Treas. Reg. § 1.1502-11 (computing consolidated taxable income for the group) (App. D, at 44a); Treas. Reg. § 1.1502-21(f) (calculating the consolidated net operating loss) (App. D, at 54a). The consolidated return regulations nowhere discuss the ten-year carryback section 172.

3. The consolidated return regulations draw a distinction between the tax treatment of "consolidated return years" and "separate return years" of affiliated groups. A consolidated return year is any year for which the affiliated group files a consolidated federal income tax return. Treas. Reg. § 1.1502-75(a) (App. D, at 54a-55a). The term "separate return year" means "a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group." Treas. Reg. § 1.1502-1(e) (App. D, at 43a). The consolidated return regulations place restrictions on the ability of an affiliated group to carry back to consolidated return years net operating losses incurred in separate return years, and vice versa. *See* Treas. Reg. § 1.1502-79(a) (App. D, at 55a). Petitioner's claim in this case, however, does not involve

any separate return years, either with respect to the years the expenses at issue were incurred or with respect to the years to which they would be carried.

4. Petitioner is a North Carolina corporation and the parent of an affiliated group of corporations that elected to file consolidated tax returns for tax years 1983 through 1986. For each of those years, Petitioner reported a consolidated net operating loss, as determined under Treas. Reg. § 1.1502-21(f). In each of those years, Petitioner also incurred deductible expenses attributable to product liability, as defined in section 172(j)(1). Petitioner's product liability expenses were incurred by five of Petitioner's twenty-six group members. For the years in question, these five members had positive "separate taxable income," as defined in Treas. Reg. § 1.1502-12.

In 1986 and 1987, Petitioner filed with the Internal Revenue Service (the "IRS") claims for refund with respect to its 1983 through 1986 consolidated tax returns. In its claim, Petitioner asserted that it was entitled, under section 172(b)(1)(I) of the Code, to carry back up to ten years the amount of its product liability expenses incurred in 1983 through 1986. The effect of this carryback would be to reduce Petitioner's taxable income in 1973 through 1976, when Petitioner was profitable, instead of during 1983 through 1986, when Petitioner incurred a consolidated net operating loss. The amount of Petitioner's claim at issue in this case is $1,618,306, plus statutory interest.

5. The IRS agent assigned to review Petitioner's claim for refund allowed the claim with respect to Petitioner's consolidated return years. The agent allowed Petitioner to carry back the product liability expenses incurred during

consolidated return years to offset Petitioner's consolidated taxable income for the years 1973 through 1976. The agent agreed with Petitioner that, for consolidated return years, the term "product liability loss" is determined on a consolidated, group-wide basis.

The Joint Committee on Internal Revenue Taxation, however, reversed the agent's decision and denied Petitioner's claim. The Joint Committee determined that a consolidated group's "product liability loss" must be calculated at the level of each individual group member as if it filed a separate return. Accordingly, the Joint Committee found that Petitioner had no product liability loss because the individual group members that incurred Petitioner's product liability expenses had positive separate taxable income.

6. As a result of the Joint Committee's denial, Petitioner filed a timely suit for refund of federal income taxes in the United States District Court for the Western District of North Carolina. The jurisdiction of the district court was invoked under 28 U.S.C. § 1346(a)(1) and 26 U.S.C. § 7422. In light of the absence of any factual dispute, the parties submitted cross-motions for summary judgment.

In an order dated and filed June 19, 1998 (App. B), the district court granted Petitioner's cross-motion for summary judgment and denied the IRS's cross-motion for summary judgment. The district court held that Petitioner was entitled to the ten-year carryback under section 172(b)(1)(I). The district court reasoned that, with respect to consolidated return years, the amount of the ten-year carryback should be determined on a consolidated basis, not on a separate-company basis, as the IRS contended. (App. B, at 38a–39a).

The district court accordingly entered judgment for Petitioner, awarding a refund in the amount of $1,618,306, plus statutory interest. On September 14, 1998, the IRS filed a notice of appeal.

On March 24, 2000, the Fourth Circuit Court of Appeals reversed the judgment of the district court and remanded the case for further proceedings. The court of appeals rejected the consolidated return approach of the district court. Instead, the court of appeals determined that Petitioner's entitlement to the ten-year carryback for consolidated return years should be determined as if all members of the group had filed separate returns.

The court of appeals, however, also rejected the IRS's methodology for determining the amount of the ten-year carryback. The court applied its own methodology for performing the calculation, based upon Treas. Reg. § 1.1502-79(a). The function of this regulation is to apportion a consolidated net operating loss to separate return years of group members, although no separate return years were involved in this case. The effect of the Fourth Circuit's decision was to eliminate Petitioner's product liability losses. The Fourth Circuit denied Petitioner's petition for rehearing and suggestion for rehearing en banc on May 19, 2000.

REASONS FOR GRANTING THE WRIT

A principal purpose for the Court's certiorari jurisdiction is to resolve conflicts among the United States courts of appeals concerning the meaning of provisions of federal law. *See Braxton v. United States*, 500 U.S. 344, 347 (1991). The Fourth Circuit's decision in this case directly conflicts with the Sixth Circuit's decision in *Intermet Corporation & Subsidiaries v. Commissioner* (App. E), a decision filed less

than one month later. In reviewing a taxpayer's entitlement to the ten-year carryback under a successor provision to section 172(b)(1)(I), the Sixth Circuit explicitly rejected the approach taken by the Fourth Circuit in this case. (App. E, at 75a-74a). This Court regularly has granted certiorari to resolve such disputes. *See, e.g.*, *Nicholas v. United States*, 384 U.S. 678, 681 (1966) (reviewing a conflict between two circuits regarding the interpretation of the federal income tax laws); *United States v. O'Malley*, 383 U.S. 627, 630 (1966) (same); *Bruning v. United States*, 376 U.S. 358, 359 (1964) (same); *Commissioner v. Gillette Motor Trans., Inc.*, 364 U.S. 130, 133 (1960) (same); *Meyer v. United States*, 364 U.S. 410, 411 (1960) (same); *Haynes v. United States*, 353 U.S. 81, 83 (1957) (same); *Millinery Ctr. Bldg. Corp. v. Commissioner*, 350 U.S. 456, 458–59 (1956) (same).

Jurisdiction is particularly appropriate where, as here, the circuit conflict neatly presents an important and recurring question in the administration of the federal income tax laws. *See Donaldson v. United States*, 400 U.S. 517, 522 (1971); *United States v. Correll*, 389 U.S. 299, 301 (1967); *Commissioner v. Duberstein*, 363 U.S. 278, 283 (1960); *Commissioner v. Hansen*, 360 U.S. 446, 450 (1959); *Colony, Inc. v. Commissioner*, 357 U.S. 28, 31–32 (1958). The conflict driven by the Fourth Circuit's opinion will create widespread and continuing uncertainty in corporate business planning and, in addition, will raise the specter of inappropriate judicial rulemaking in a complicated area of tax law, the consolidated return regulations. Accordingly, the Court should grant the petition for a writ of certiorari.

1. Both this case and *Intermet* squarely present the same interpretive problem on substantially identical facts: whether an affiliated group with a consolidated net operating loss may carry back ten years to a consolidated return year the

amount of its product liability or specified liability expenses if the individual group member that incurred those expenses had positive separate taxable income.

In this case, as in *Intermet*, the taxpayer affiliated group incurred deductible expenses that potentially qualified for the ten-year carryback. In both cases, the taxpayer group had a consolidated net operating loss. In both cases, the taxpayer group incurred the expenses at issue in consolidated return years, not in separate return years. In both cases, the taxpayer group sought to carry the qualifying expenses back to consolidated return years, not to separate return years. In both cases, however, the individual group members that incurred the qualifying expenses had positive "separate taxable income" under the consolidated return regulations.

The IRS contended in both cases that the taxpayer was not entitled to the ten-year carryback for the designated expenses because those expenses somehow vanished into the positive separate taxable income of the members that incurred them. The IRS argued that a taxpayer group's entitlement to the ten-year carryback is subject to two independent limitations: the group member incurring the qualifying expenses must have its own "separate company net operating loss" (despite the fact that no such concept exists for consolidated return years), and the consolidated group as a whole must have a consolidated net operating loss. Thus, taking this case as an example, the IRS contended that Petitioner could not have a product liability loss under section 172(b)(1)(I) because the individual members that incurred Petitioner's product liability expenses had positive separate taxable income, and hence none of the expenses could survive to be considered at the consolidated level.

By contrast, Petitioner here and the taxpayer in *Intermet* both argued that a taxpayer's entitlement to the ten-year carryback is determined at the consolidated-group level for consolidated return years. First, the statute itself defines "product liability loss" and "specified liability loss" with reference to "a taxpayer," and the group as a whole is the *only* taxpayer with respect to consolidated return years.

Second, section 172 calculates a taxpayer's product liability loss or specified liability loss by comparing the taxpayer's qualifying expenses with the taxpayer's "net operating loss." The only net operating loss that exists for affiliated groups in consolidated return years is the "consolidated net operating loss," as defined in Treas. Reg. § 1.1502-21(f). While an individual group member may have negative separate taxable income, the consolidated return regulations contain no such concept as a separate company net operating loss for consolidated return years. Hence, the IRS comparison of product liability expenses with separate taxable income is statutorily meaningless.

Third and finally, Petitioner and the taxpayer in *Intermet* argued that the expenses in question were "taken into account," as required by the statute, in computing each taxpayer's consolidated net operating loss. Any increase or decrease in the amount of Petitioner's product liability expenses, for example, would result in an *exactly equivalent* increase or decrease in Petitioner's consolidated net operating loss. In sum, Petitioner and the taxpayer in *Intermet* both argued that a taxpayer's entitlement to the ten-year carryback must be determined at the consolidated-group level for consolidated return years.

Therefore, the statutory and regulatory provisions, the facts, and the arguments of the parties were substantially identical in this case and in *Intermet*.

2. The Fourth Circuit in this case created a new and fundamentally flawed "judicial" consolidated return regulation. In its opinion, the Fourth Circuit endorsed the IRS's misreading of the statute and regulations by limiting Petitioner's product liability loss to the sum of each member's separate-return product liability losses. The Fourth Circuit, however, then departed from the IRS's brief by restricting further each member's product liability loss to the lesser of two items: the member's product liability expenses and the member's "separate return net operating loss" under Treas. Reg. § 1.1502-79(a) (App. A, at 23a).

On its face, the regulation cited by the Fourth Circuit, Treas. Reg. § 1.1502-79(a), simply does not apply. The sole function of that regulation is to determine "[i]f a consolidated net operating loss can be carried . . . *to a separate return year* of a corporation . . . which was a member in the year in which such loss arose." Trans. Reg. § 1.1502-79(a)(1) (emphasis added). As noted above, *no separate return years are at issue in this case* (or in *Intermet*). Accordingly, the Fourth Circuit's application of Trans. Reg. § 1.1502-79(a) only can be construed as a new regulation which imposes separate return concepts and provisions to the determination of consolidated return items. The scope of this new provision is unclear. The Fourth Circuit cited no technical or policy support for its regulation and therefore suggested no limiting rationale. This Court should review the Fourth Circuit's arbitrary and irrational approach to interpreting federal income tax laws.

3. In contrast to the Fourth Circuit's usurpation of regulatory authority from the IRS, the Sixth Circuit's decision in *Intermet* harmonized the plain language of section 172 with the existing consolidated return regulations in a manner that is both equitable and easily administrable.

The Sixth Circuit in *Intermet* sensibly rejected both the reasoning and the result of the Fourth Circuit's decision in this case. The Sixth Circuit held that an affiliated group's entitlement to the ten-year carryback for consolidated return years is determined on a consolidated basis. The court of appeals reasoned that separate taxable income is "simply a step along the way to calculating the group's taxable income or [consolidated net operating loss]" and therefore has "no independent significance" in determining a taxpayer's specified liability loss. (App. E, at 71a). According to the court of appeals, the only "net operating loss" in question is the consolidated net operating loss determined under Treas. Reg. § 1.1502-21(f).

In *Intermet*, the Sixth Circuit considered the Fourth Circuit's approach and expressly rejected it as unpersuasive:

> When reading section 1.1502-79A(a)[1] as a whole, there is no question that it applies only to the separate return scenario. . . . We note that the Fourth Circuit recently held that a consolidated taxpayer is entitled to a "product liability loss" carryback — comparable to the [specified liability loss] carryback—for that portion of an individual

1. Treas. Reg. § 1.1502-79A(a) is the same regulation as Treas. Reg. § 1.1502-79(a). Courts sometimes add the capital letter "A" to regulations in order to designate a regulation promulgated under the Internal Revenue Code of 1954.

> member's product liability expenses that does not exceed the member's "separate net operating loss" as calculated under section 1.1502-79A(a)(3). . . . The court offered no analysis to support its conclusion that Treas. Reg. § 1.1502-79A(a)(3) dictates a method for calculating a member's "separate net operating loss" outside of the separate return context. . . . For the reasons outlined above, we are unpersuaded by the Fourth Circuit's approach.

(App. E, at 73a-74a). The Sixth Circuit therefore held that the taxpayer's entitlement to the ten-year carryback should be determined by comparing the taxpayer's qualifying expenses with its consolidated net operating loss. The Court should resolve the conflict presented in favor of the Sixth Circuit's opinion in *Intermet*.

4. The Court should review the Fourth Circuit's opinion to resolve the uncertainty the opinion creates with respect to corporate restructurings and with respect to the role of the judiciary in the administration of the federal income tax laws.

a. The Fourth Circuit's ruling creates a trap for the unwary. For example, an imperiled corporation that restructures its operations by contributing its various lines of business into separate corporations unwittingly may foreclose its access to the ten-year carryback if the business that incurs qualifying expenses happens to be profitable. The Sixth Circuit's opinion eliminates this trap by preserving single-entity treatment for the group as a whole. As the Sixth Circuit noted, the IRS itself has favored single-entity treatment in the past. (App. E, at 71a-72a). The Court should resolve the conflict between the Fourth and Sixth Circuits to simplify the administration of the federal income tax laws.

b. Just as they do not write laws, courts generally do not write regulations. This prohibition applies with added vigor in the case of the consolidated return regulations, which are legislative in character. *See generally* S. Rep. No. 70-960, at 15 (1928) ("The committee believes it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the commissioner to prescribe regulations legislative in character."). Petitioner's case provides a good example of why courts must not take it upon themselves to write their own regulations. The Fourth Circuit's method of apportioning the consolidated net operating loss to individual group members completely distorts the operation of section 172.

With no supporting rationale, the Fourth Circuit's approach adds Byzantine complexity to an already complex area of the law. Petitioner and the taxpayer in *Intermet* assert that the ten-year carryback amount is the lesser of the group's consolidated net operating loss or the group's product liability expenses. The IRS, by contrast, contends that the ten-year carryback amount is the least of the group's consolidated net operating loss, the sum of each member's product liability expenses, and the sum of each of those particular members' negative separate taxable incomes. The Fourth Circuit, however, would limit the ten-year carryback amount to the least of the group's consolidated net operating loss, the sum of each member's product liability expenses, and the sum of each of those particular members' shares of the group's consolidated net operating loss, apportioned on the basis of the members' relative size. This convoluted calculation, devoid of reason, produces arbitrary and capricious results. Take the following illustration:

A consolidated group consists of a parent corporation and three wholly owned subsidiaries. The parent has no income or loss. Subsidiary A has a loss of $500, of which $100 is attributable to product liability expenses. Subsidiary B has a loss of $10,000. Subsidiary C has income of $10,400. Thus, the taxpayer group has a consolidated net operating loss of $100 ($10,400 - $10,000 - $500).

If Subsidiary A had filed a return as an individual taxpayer, it would have had a product liability loss of $100 (the lesser of the $500 individual loss or the $100 product liability expense), which it could carry back ten years. Under the taxpayer's methodology, the taxpayer affiliated group would have a product liability loss of $100 (the lesser of the $100 group loss or the $100 product liability expense). Even under the IRS approach, misguided as it is, the taxpayer group would have a product liability loss of $100 (the least of the $100 group loss, the $500 negative separate taxable income, or the $100 product liability expense).

Under the Fourth Circuit's approach, however, the group would have a product liability loss of only *$4.76* (the least of the $100 group loss, the $100 product liability expense or, under Reg. § 1.1502-79(a), the $100 group loss, multiplied by Subsidiary A's loss of $500, divided by the sum of all separate losses, $10,500). This unwarranted result occurs solely because the bulk of the group's loss happens to have been incurred by a member with no product liability deductions. No policy rationale exists for determining the ten-year carryback in this arbitrary manner. The Fourth Circuit simply took an unrelated regulation and crammed it in where it did not belong.The Court should bring the Fourth Circuit's decision into conformity with the rational approach offered by the Sixth Circuit's decision in *Intermet*.

5. This case presents the Court with a unique opportunity to resolve the conflict neatly presented by these two cases. The Court is unlikely to find a better case to resolve the conflict at hand. The facts and legal issue in this case and in *Intermet* are virtually identical. The split between the circuits is clear. This case does not burden the Court with extraneous matters, such as the availability of the ten-year carryback for separate return expenses in consolidated return years (or vice versa). To the best of Petitioner's knowledge, no case regarding this issue is currently before a federal court, but Petitioner is aware that this issue has been raised with respect to other taxpayers at the examination stage. The issue presented in these two cases potentially affects all affiliated groups filing consolidated returns. If the issue in this case is left unresolved, then ultimately the IRS, the private sector, and the courts will expend substantial resources developing cases which will not present the issue in question as sharply and cleanly as this case does.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

ERIC R. FOX
Counsel of Record
DIRK J.J. SURINGA
IVINS, PHILLIPS & BARKER
Attorneys for Petitioner
1700 Pennsylvania Avenue, N.W.
Washington, DC 20006
(202) 393-7600

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DATED AND DECIDED MARCH 24, 2000

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 98-2380

UNITED DOMINION INDUSTRIES, INCORPORATED,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Appeal from the United States District Court
for the Western District of North Carolina, at Charlotte.
Graham C. Mullen, Chief District Judge.
(CA-95-341-MU)

Argued: December 2, 1999

Decided: March 24, 2000

Before TRAXLER and KING, Circuit Judges, and
Margaret B. SEYMOUR, United States District Judge
for the District of South Carolina,
sitting by designation.

* * *

Appendix A

OPINION

KING, Circuit Judge:

The question in this case arises from the filing of consolidated tax returns by the predecessor of plaintiff United Dominion Industries, Incorporated (the "taxpayer" or "AMCA"[1]). The taxpayer and the Government (the "IRS") disagree on how to determine the amount of the taxpayer's product liability expenses that may be characterized as "product liability loss."

The IRS appeals from the district court's judgment ordering tax refunds and statutory interest payments to the taxpayer. This dispute involves AMCA's consolidated tax returns for tax years 1983, 1984, 1985, and 1986. On those returns, AMCA characterized the product liability expenses incurred by five of AMCA's twenty-six group members as "product liability loss," which permitted a ten-year carry-back of those losses. The five group members, however, each had positive "separate taxable income," as defined by the consolidated return regulations, in each of the relevant tax return years. The issue on appeal is whether, under these circumstances, these five group members' product liability expenses are properly characterized as "product liability loss" on AMCA's consolidated returns.

The district court entered summary judgment in favor of the taxpayer after the IRS and the taxpayer filed cross-motions for summary judgment. We possess jurisdiction

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1. "AMCA" (AMCA International Corporation) was the predecessor corporation of United Dominion Industries, Incorporated.

pursuant to 28 U.S.C. § 1291. For the reasons explained below, we reverse and remand.

I.

AMCA was the parent of an affiliated group of corporations that properly elected to file consolidated tax returns for tax years 1983 through 1986. In those consolidated tax returns, relying on 26 U.S.C. § 172 (defining "product liability loss" and relevant carryback period, for individual tax returns), AMCA claimed "product liability loss" deductions arising from its group members' product liability expenses.[2] The product liability expenses of five of AMCA's twenty-six group members are at issue in this case. Those members are: Jesco, Inc.; the Cherry-Burrell Corp.; Amtel, Inc.; and Amtel's two subsidiaries, Litwin Corp. and Litwin Panamerican Corp.

The parties agree that the product liability expenses incurred by the five group members in the relevant years total $1,618,306. The parties also agree that during each of the relevant tax years, AMCA's "consolidated net operating loss" was much larger than the product liability expenses that are in dispute. However, with respect to the challenged refunds, the five group members also had positive "separate taxable income" in each of the relevant tax years.[3]

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2. The citations to the Internal Revenue Code and Treasury Regulations in this opinion refer to the respective versions thereof that were in effect between 1983 and 1986.

3. Of note, *see infra* Part III.B.2, the record does not reflect the five group members' "separate net operating loss" for each of

(Cont'd)

Appendix A

The taxpayer seeks to apply product liability expenses deductions to AMCA's consolidated tax returns for four years (1983, 1984, 1985, and 1986) for each of these five group members, except in two cases — Amtel in 1983, and Litwin in 1984.[4] The taxpayer sought to characterize all of the five group members' product liability expenses deductions as "product liability loss." Further, the taxpayer seeks to carryback these deductions ten years, pursuant to § 172(b), to AMCA's corresponding consolidated tax returns for tax years 1973 through 1976.[5] The IRS contends that this position

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the relevant years, although Amtel, Litwin, and Litwin Panamerican each appear to have had zero separate net operating loss in 1985. *See Amtel, Inc. v. United States*, 31 Fed. Cl. 598, 601 (1994) (applying Treas. Reg. § 1.1502-79(a)(3) to calculate AMCA's group members' separate net operating loss), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995) (table).

4. The taxpayer concedes that AMCA is not entitled to claim on its 1984 consolidated return a $4,198 product liability loss attributable to one of its group members, Litwin, even though for that year Litwin had a large net operating loss. *See* Brief for Plaintiff-Appellee at 26. The regulations disallow a ten-year carryback of this $4,198 on AMCA's consolidated return, because Litwin was not a member of AMCA's affiliated group in 1974; the loss must therefore be carried back to Litwin's 1974 separate return year. *See* Treas. Regs. §§ 1.1502-21(b)(1) (permitting "consolidated net operating loss" carryovers and carrybacks); 1.1502-79(a) (directing that certain "consolidated net operating loss" carryovers and carrybacks be allocated to separate return years).

5. Cherry-Burrell was formed by AMCA in 1975. The remaining four group members were acquired by AMCA after 1976.
(Cont'd)

is erroneous, asserting that because the group members each had positive "separate taxable incomes," their product liability expenses are not "product liability loss." Consequently, according to the IRS, these expenses may not be carried back more than three years.

After the parties agreed there was no genuine issue of material fact, the district court granted summary judgment to the taxpayer on the question of law presented by the cross-motions for summary judgment. In doing so, the court determined that the taxpayer may properly characterize all of its group members' product liability expenses as "product liability loss," because the five group members' aggregated product liability expenses were less than AMCA's consolidated net operating loss. The court accordingly ordered the IRS to refund the taxpayer the sum of $1,618,306 in disputed tax payments, plus statutory interest. We find this decision to be in error, for the reasons explained below.

II.

A.

In the case of a taxpayer who files a separate individual tax return, the tax code establishes a basic framework for

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Whether these members existed or had been acquired by AMCA at that earlier time is not material to our decision today on whether a group member's product liability expenses are properly characterized as "product liability loss," although such facts may be relevant to whether deductions must be carried back to a separate or to a consolidated return year. *See supra* note 4.

determining the amount of product liability expenses that may be characterized as "product liability loss." The difference between the taxpayer's gross income and its allowable deductions reflects either the taxpayer's taxable income, or — if the allowable deductions exceed the gross income — its net operating loss. *See, e.g.*, 26 U.S.C. §§ 63(a) (defining taxable income), 172(c) (defining net operating loss). If a net operating loss results, the taxpayer may characterize its product liability expenses as "product liability loss," to the extent that such expenses do not exceed the taxpayer's net operating loss. *See* 26 U.S.C. § 172(j) (defining "product liability loss" on an individual tax return).[6] Under § 172(j), any "product liability loss" cannot exceed the taxpayer's "net operating loss."

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6. In the context of separate tax returns, § 172 defines the portion of product liability expenses that may be characterized as "product liability loss":

> The term "product liability loss" means, for any taxable year, the lesser of —
>
> (A) the net operating loss for such year . . . , or
>
> (B) the sum of the amounts allowable as deductions under section 162 and 165 which are attributable to —
>
> (i) product liability, or
>
> (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

26 U.S.C. § 172(j)(1).

For example, a taxpayer with a net operating loss of fifty dollars and product liability expenses of seventy-five dollars may characterize no more than fifty dollars of its product liability expenses as "product liability loss." The advantage of such a characterization to the taxpayer is that a deduction for "product liability loss" may be carried backward or forward for up to ten years, rather than the three-year period that is generally available for loss deductions. *See* 26 U.S.C. § 172(b)(1)(A), (I) (defining carryover and carryback time periods).[7] Because on an individual tax return, a taxpayer

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7. For a separate tax return, § 172 also defines the net operating loss carryback provisions:

> (b) Net operating Loss Carrybacks and Carryovers. —
>
> (1) Years to which loss may be carried. —
>
> (A) Except as provided in subparagraphs . . . (I), . . . , a net operating loss for any taxable year shall be a net operating loss carryback to each of the 3 taxable [years preceding] the taxable year of such loss.
>
> . . .
>
> (I) Product liability losses. — In the case of a taxpayer which has a product liability loss (as defined in subsection (j)[)] for a taxable year beginning after September 30, 1979 (referred to in this subparagraph as the "loss year"), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years [preceding] the loss year.

26 U.S.C. § 172(b).

with positive taxable income has no "net operating loss," a corollary is that a taxpayer with positive taxable income must have zero "product liability loss," notwithstanding the amount of its product liability expenses. This is true because the taxpayer must have a net operating loss before any of its product liability expenses may be classified as "product liability loss."

B.

An affiliated group of corporations may properly elect to file a consolidated tax return through the parent corporation, rather than filing individual tax returns for each of the group members. *See* 26 U.S.C. §§ 1501-1505 (authorizing consolidated tax returns). Consolidated tax return calculations have both similarities to, and certain distinctions from, those applicable to individual tax returns.

The consolidated tax return regulations require that some information be calculated separately for each group member, similar to calculations that would be necessary had that member filed its own individual tax return. The "separate taxable income" for a group member is calculated in accordance with the tax code provisions covering the determinations of taxable income of separate corporations, subject to modifications. *See* Treas. Reg. § 1.1502-12 (defining "separate taxable income").[8] One such

8. The "separate taxable income" of a group member excludes deductions that are attributable to certain consolidated amounts, as specified in Treas. Reg. § 1.1502-12 subsections:

(Cont'd)

modification, for example, is that no net operating loss deduction may be taken into account when computing a group member's "separate taxable income." *See id.*

Thus, pursuant to the consolidated returns regulations, some important and relevant tax return information from the group members is not included in these per-group-member calculations. Instead, that tax return information is separately designated and utilized in consolidated form. These consolidated amounts and the per-group-member amounts are then combined into the parent corporation's "consolidated taxable income," which accumulates all the relevant information by taking into account: (i) the "separate taxable income of each member of the group;" and (ii) deductions attributable to seven different consolidated amounts, *e.g.*, any "consolidated net operating loss" deduction, and any

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(Cont'd)

(h) (net operating loss);

(j) (capital gains or losses);

(k) (gains or losses subject to section 1231);

(l) (section 170 charitable contributions);

(m) (section 922 (relating to the deduction for Western Hemisphere trade corporations)); and

(n) (dividends received and dividends paid, pursuant to sections 243(a)(1), 244(a), 245, or 247).

See Treas. Reg. § 1.1502-12.

consolidated charitable contributions deduction. *See* Treas. Reg. § 1.1502-11(a) (generally defining "consolidated taxable income").[9]

C.

The question in this case — how to properly determine the amount of product liability expenses that may be

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9. The "consolidated taxable income" for a consolidated tax return is determined pursuant to Treas. Reg. § 1.1502-11(a), by taking into account:

(1) each group member's "separate taxable income;"

(2) any consolidated net operating loss deduction;

(3) any consolidated capital gain net income . . . ;

(4) any consolidated section 1231 net loss;

(5) any consolidated charitable contributions deduction;

(6) any consolidated section 922 deduction;

(7) any consolidated dividends received deduction;

(8) any consolidated section 247 deduction.

See Treas. Reg. § 1.1502-11(a). The above deductions, taken into account in calculating the parent's "consolidated taxable income" pursuant to Treas. Reg. § 1.1502-11(a), mirror those deductions excluded from the calculation of a group member's "separate taxable income" pursuant to Treas. Reg. § 1.1502-12. *See supra* note 8.

characterized as "product liability loss" on a consolidated tax return — arises because, before such expenses may be characterized as "product liability loss," a preliminary determination must be made that a net operating loss has occurred. *Cf.* 26 U.S.C. § 172(j) (defining "product liability loss" on an individual tax return); *see* discussion *supra* Part II.A. Both the tax code and the regulations are silent as to whether this "product liability loss" characterization should be determined on a per-group-member basis or on a consolidated basis. The regulations, however, lay the groundwork for this determination by defining several relevant terms: the group members' "separate taxable income" (*see* Treas. Reg. § 1.1502-12) and "separate net operating loss" (*see* Treas. Reg. § 1.1502-79(a)); and the parent corporation's "consolidated taxable income" (*see* Treas. Reg. § 1.1502-11) and "consolidated net operating loss" (*see* Treas. Reg. § 1.1502-21(f)).

On a consolidated tax return, each group member has its associated "separate taxable income." A group member's "separate taxable income" is not analogous to a corporation's taxable income on an individual tax return, however, because unlike the individual's taxable income, the "separate taxable income" does not reflect the full extent of that group member's profitability or loss. This is so because, on consolidated tax returns, some deductible amounts attributable to the group member are instead reflected elsewhere, in consolidated form. *See supra* note 8 (*e.g.*, net operating loss not taken into account in group member's "separate taxable income").

The consolidated deductions that are not reflected in the group member's "separate taxable income" but are fairly

attributable to the group member, are, however, reflected in the "separate net operating loss" of the group member. The "separate net operating loss" of a group member is determined from the "separate taxable income," with adjustments for certain items, including items taken into account in the computation of the consolidated net operating loss. *See* Treas. Reg. § 1.1502-79(a)(3) (formula for apportioning "consolidated net operating loss" to a member, when carryback must go to the member's separate return year).[10] As a result of the incorporation of the consolidated

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10. The "separate net operating loss" of a group member as defined in Treas. Reg. § 1.1502-79(a)(3) (formula for apportioning "consolidated net operating loss" to a member for allocation to a separate tax return year), is determined from its "separate taxable income" under Treas. Reg. § 1.1502-12 (except that no deduction is allowed under section 242), adjusted for the group member's portion of the following items taken into account in the computation of the consolidated net operating loss:

> (i) consolidated dividends received deduction, consolidated charitable contributions deduction, and consolidated section 247 deduction;
>
> (iv) consolidated net capital loss carryover which is absorbed in the taxable year;

and adjusted for the following items taken into account in the consolidated net operating loss computation:

> (ii) the member's capital gain net income;
>
> (iii) the member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member.

See Treas. Reg. § 1.1502-79(a)(3).

deduction adjustments in the group members' "separate net operating loss" but not in their "separate taxable income," it is possible that a group member may have positive "separate taxable income" at the same time it has a positive "separate net operating loss."[11]

The consolidated tax return regulations also define the parent corporation's "consolidated taxable income," which takes into account the group members' "separate taxable incomes" and deductions attributable to seven consolidated items. *See supra* note 9. Further, the regulations also define the parent's "consolidated net operating loss," which, like its "consolidated taxable income," combines the group members' "separate taxable incomes" with enumerated consolidated deductions. *See* Treas. Reg. § 1.1502-21(f) (defining "consolidated net operating loss").[12]

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11. This is importantly different from the case of an individual tax return, where if either the individual's taxable income or net operating loss is positive, the other value must be zero.

12. The "consolidated net operating loss" is determined pursuant to Treas. Reg. § 1.1502-21(f) by taking into account:

(1) the group members' "separate taxable income";

(2) any consolidated capital gain net income . . . ;

(3) any consolidated section 1231 net loss;

(4) any consolidated charitable contributions deduction;

(5) any consolidated dividends received deduction; and

(6) any consolidated section 247 deduction.

See Treas. Reg. § 1.1502-21(f).

Appendix A

Having reviewed the pertinent terminology and provisions of the code and regulations, we now turn to the facts of this case to determine how the per-group-member and consolidated items apply to the question before us.

III.

Our standard of review is clear: we review de novo the grant or denial of a motion for summary judgment. *Henson v. Liggett Group, Inc.*, 61 F.3d 270, 274 (4th Cir. 1995).

A.

The taxpayer has adopted a single-entity approach in calculating its "product liability loss" for AMCA's 1983 through 1986 consolidated tax returns. The methodology is the same for each of the challenged tax years' calculations. The taxpayer's single-entity approach does not require a group member incurring deductible product liability expenses to have also incurred a net operating loss. According to the taxpayer, only AMCA's aggregated product liability expenses and net operating loss amounts are relevant to the characterization of these expenses as "product liability loss."

Specifically, the taxpayer applied the single-entity method as follows. First, for each tax year, the taxpayer aggregated all twenty-six AMCA group members' product liability expenses. *See* 26 U.S.C. § 172(j) (defining "product liability loss" on an individual tax return). The taxpayer then calculated AMCA's "consolidated net operating loss" for that tax year. *See* Treas. Reg. § 1.1502-21(f) (defining "consolidated net operating loss"). Because AMCA's

aggregated product liability expenses were less than AMCA's "consolidated net operating loss" for that tax year, and since in the case of a separate tax return, under § 172(j)(1), a corporation's product liability expenses that are less than or equal to its "net operating loss" are characterized as "product liability loss," the taxpayer characterized AMCA's aggregated product liability expenses as "product liability loss." This characterization permits the taxpayer to deduct the entirety of these expenses from income earned up to ten years prior, and to receive tax credits thereon. Under the taxpayer's view, for example, a group member with fifty dollars of product liability expenses could contribute all fifty dollars toward the "product liability loss" on the parent corporation's consolidated tax return, so long as the consolidated net operating loss was greater than the aggregate of all the group members' product liability expenses.

The IRS disagrees with the taxpayer's single-entity method for defining "product liability loss" on consolidated tax returns, and therefore rejects the taxpayer's characterization of its aggregated product liability expenses as "product liability loss." The IRS emphasizes that there are fundamental differences between relevant portions of the consolidated returns regulations and the separate returns regulations, and that the consolidated regulations take precedence here.

Put simply, we agree with the IRS that the taxpayer's single-entity method is improper. The principal advantage in filing a consolidated return is income blending: the losses of unprofitable group members can offset the income of

profitable group members and mitigate the current tax liability. *Amtel, Inc. v. United States*, 31 Fed. Cl. 598, 600 (1994), *aff'd*, 59 F.3d 181 (Fed. Cir. 1995) (table). The regulations provide for blending the group members' net operating losses, and they explicitly define a "consolidated net operating loss" without an accompanying reference to consolidated product liability expenses. This omission is important here and makes clear that blending those expenses is not permitted, *i.e.*, that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated "product liability loss" is not intended. *Cf.* 26 U.S.C. § 172(c), (j) (defining "net operating loss" and "product liability loss" on an individual tax return). This omission also confirms that product liability expenses are linked to the consolidated net operating loss only through their nexus to the group member, so that any related tax carryback benefits are therefore also tied to the group member.[13]

The IRS further contends that under the taxpayer's single-entity method of characterizing the group member's product liability expenses, the parent corporation obtains a

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13. The enumerated modifications taken into account when computing a group member's "separate taxable income" do not refer to product liability losses. The calculation of a group member's "separate taxable income" therefore includes the member's product liability expense deduction. *See, e.g.*, 26 U.S.C. §§ 162 (permitting trade or business expense deductions), 165 (permitting deductions for loss), 172(j)(1) (defining "product liability loss"). Further, product liability loss is not referred to in the "consolidated net operating loss" definition.

windfall tax benefit. We agree that, were the taxpayer's reasoning to prevail, the parent corporation could obtain the extended ten-year carryback for losses incurred by individual group members (that are reflected in the parent's "consolidated net operating loss"), although the losses were not the result of product liability expenses (and thus could not be "product liability loss"). This occurs by the parent corporation's characterization of all of a group member's product liability expenses as "product liability loss," even though some of these expenses came from group members that incurred no "separate net operating loss." Because the tax regulations plainly provide the ten-year carryback only for "product liability loss" (and not for product liability expenses), we conclude that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations.

B.

Having rejected the taxpayer's single-entity method for determining "product liability loss" on a consolidated return, we now turn to establishing the proper method for doing so. We conclude that determining "product liability loss" separately for each group member is correct and consistent with the regulations. The regulations suggest two possible methods, however, for determining "product liability loss" from a group member's product liability expenses. Under these possible methods of calculation, a member's "product liability loss" may be either: (a) the amount of product liability expenses that do not exceed the group member's negative "separate taxable income," or (b) the amount of

product liability expenses that do not exceed the group member's "separate net operating loss."

1.

The IRS proposes that the group member's negative "separate taxable income," calculated pursuant to Treas. Reg. § 1.1502-12, should establish the threshold for determining the group's "product liability loss" amount. To the contrary, we agree with the taxpayer that the IRS's proposed method for determining "product liability loss" on consolidated returns is incorrect.

The IRS contends that whether a portion of a group member's product liability expenses can be characterized as "product liability loss" turns on whether the group member had a negative "separate taxable income." The IRS thus proposes that the "net operating loss" on a separate return is most analogous to a group member's "separate taxable income" on a consolidated return. In the IRS's view, a group member with positive "separate taxable income" has no losses under the consolidated return regulations, and therefore has no "product liability loss," despite having product liability expenses. For example, the IRS urges that a group member with fifty dollars of product liability expenses and negative ten dollars "separate taxable income" could contribute no more than ten dollars toward the "product liability loss" on the parent corporation's consolidated tax return.

The taxpayer points out that the group member's "separate taxable income" is not analogous to a net operating

loss on a separate return, because "separate taxable income" by definition excludes income and deductions that would be incorporated in calculating the group member's taxable income or net operating loss, if the group member had filed a separate tax return. *See* Treas. Reg. § 1.1502-12 (defining "separate taxable income"). Therefore, the taxpayer says, the "separate taxable income" cannot be an appropriate reference for determining whether the group member incurred a loss from product liability expenses. We agree. *See* discussion *supra* Part II.C.

On a separate tax return, the net operating loss is the amount by which the allowable deductions exceed the taxpayer's gross income. *See* 26 U.S.C. § 172(c) (defining net operating loss). Allowable deductions include deductions attributable to, *e.g.*, charitable contributions and net operating loss.[14] *See, e.g.*, 26 U.S.C. §§ 170 (charitable contributions), 172(a) (net operating loss). Thus, the net operating loss as defined on a separate return reflects that, in a broad sense, the taxpayer had more expenditures than income. On a consolidated return, the "separate taxable income" does not reflect an analogous difference between a group member's income and expenses, because expenses that are fairly attributable to the group member are excluded from the "separate taxable income." For example, a member's charitable contributions and attributable net operating loss deductions are excluded from its "separate taxable income," and instead are included elsewhere, in consolidated form only. *See, e.g.*, Treas. Reg. §§ 1.1502-12 ("separate taxable

14. A net operating loss deduction may be available, for example, by the taxpayer's carryback or carryforward from another tax year.

income"), 1.1502-11(a) (listing consolidated items). Thus, a group member may have a positive "separate taxable income" notwithstanding that the member had a charitable contribution of, say, two or three times the amount of its "separate taxable income." According to the view of the IRS, the member's positive "separate taxable income" would bar any of that member's product liability expenses from being characterized as "product liability loss."

We are constrained to reject the position taken by the IRS. The result in our above example is flatly contrary to the separate tax return analogy from § 172(j) — there, if an individual's charitable contribution exceeds its gross income, a net operating loss results. This net operating loss would therefore permit the individual taxpayer's product liability expenses to be characterized as "product liability loss."[15] Further, the IRS presents no affirmative reason to justify using a group member's "separate taxable income" to limit the member's contribution to "product liability loss," and we conclude there is none. A group member can, and often will, have a net operating loss (in the sense of § 172, after accounting for all the amounts attributable to that member), despite the member's positive "separate taxable income." *See supra* note 11. In such a case, the group member's product liability expenses may qualify as "product liability loss." Having rejected the IRS's proposed reference to the member's "separate taxable income" in the determination of whether the member's product liability expenses are "product liability loss," we must go further, and consider

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15. The "product liability loss" amount would be limited, of course, by the amount of the net operating loss. *See* 26 U.S.C. § 172(j).

how to properly determine "product liability loss" on a consolidated return.

The taxpayer argues that "product liability loss" is determined by reference to net operating loss. We agree with this assertion. However, the taxpayer goes further, and claims that for a consolidated return, the net operating loss only exists on a consolidated basis. *See* 26 U.S.C. § 172(j)(1) (defining "product liability loss" on an individual tax return); Treas. Reg. § 1.1502-21(f) (defining "consolidated net operating loss"). Therefore, the taxpayer asserts, product liability expenses must also be consolidated in order to compare those expenses to the consolidated net operating loss, so as to calculate the "product liability loss." On this point, we disagree with the taxpayer.

2.

The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

First, the regulations define the portion of the consolidated net operating loss that is attributable to a group

member.[16] *See* Treas. Reg. § 1.1502-79(a) (apportionment of consolidated net operating loss to a group member, for purposes of carrying back to a separate return year).[17] Application of this apportionment formula to the issue in this case results in logical consistency of the general consolidated return framework, and the specific resolution of the issue in this case.

A group member's "separate net operating loss" incorporates the portion of the consolidated net operating loss allocated to that member (calculated pursuant to Treas. Reg. § 1.1502-79(a)(3)), and is analogous to a § 172(c) net operating loss. That is, the member's "separate net operating loss" takes into account, for example, that member's charitable contributions and net operating loss deductions — and in this sense, it is unlike the member's "separate

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16. A group member's portion of the consolidated net operating loss is:

> the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of such corporation, and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses.

Treas. Reg. § 1.1502-79(a)(3). The regulation further provides the method for determining the "separate net operating loss" of a group member. *Id. See also supra* note 10.

17. The amount of net operating loss apportioned to a group member does not and should not depend upon whether any resulting carryback will be applied to a separate or a consolidated return year.

taxable income."[18] Therefore, a group member's product liability expenses that are not in excess of that group member's "separate net operating loss" is that member's "product liability loss," analogous to § 172(j). The sum of the group members' "product liability loss" provides the parent corporation's total "product liability loss."[19] For example, a group member with fifty dollars of product liability expenses, negative ten dollars "separate taxable income," and fifteen dollars "separate net operating loss" could contribute a maximum of fifteen dollars toward the "product liability loss" on the parent corporation's consolidated tax return.

The tax carryback benefits available to the parent corporation from the group member's product liability expenses are thus properly limited by the group member's portion of the consolidated net operating loss, analogous to the limit that would be imposed if the group member had filed a separate tax return. Our resolution today maintains the required nexus between a group member's net operating loss and its product liability expenses, as implied by the consolidated return regulations, in the definition of the "product liability loss" deduction on a consolidated return.

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18. A group member's "separate net operating loss" is more analogous than its "separate taxable income" to the § 172 "net operating loss" on an individual tax return. *See* discussion *supra* Part III.B.1.

19. If a group member's portion of the consolidated net operating loss must be carried back to the group member's separate return year, pursuant to Treas. Reg. § 1.1502-79, then the "product liability loss" for that group member must likewise be carried back to the group member's separate return year. *Cf. supra* note 4.

IV.

In conclusion, we reject the taxpayer's single-entity approach to the determination of "product liability loss" on a consolidated return. Instead, we conclude that each group member's "product liability loss" must be appropriately determined, and that the parent's "product liability loss" is calculated as the aggregate of the group members' "product liability loss." As to the proper method to determine each group member's "product liability loss," we reject the position of the IRS that a group member's "product liability loss" is its product liability expenses to the extent that those expenses are not in excess of the group member's negative "separate taxable income."

We therefore hold that, on a consolidated return, a group member's product liability expenses that do not exceed that member's "separate net operating loss," calculated pursuant to Treas. Reg. § 1.1502-79(a)(3), may be characterized as "product liability loss." We further hold that the parent's "product liability loss" is properly determined as the aggregate of its group members' "product liability loss."

Pursuant to the foregoing, we reverse the judgment of the district court and remand this case for further proceedings consistent with this decision.

REVERSED AND REMANDED

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NORTH CAROLINA, CHARLOTTE DIVISION DATED AND FILED JUNE 19, 1998

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION
3:95-CV-341-MU

UNITED DOMINION INDUSTRIES, INC.,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

ORDER

This matter involves a tax dispute between United Dominion Industries, Inc., ("UDI") and the Internal Revenue Service ("IRS" or "Service"). UDI contends that the United States has erroneously denied UDI the right to carry back to the years 1973, 1974, 1975 and 1976 consolidated product liability losses arising in 1983, 1984, 1985 and 1986 in the amounts of $205,919; $1,609,340, $1,333,788 and $250,550,[1] respectively. UDI seeks judgment in the amount

1. UDI asserts that the IRS erroneously denied UDI the right to carry back $250,550 in losses arising in 1986. However, the sum of the product liability losses of the five members at issue for 1986 is $232,402.

of the corresponding refund. These figures represent the deductions attributable to product liability as defined in section 172(j) of the Internal Revenue Code of 1954 ("the Code") of five members of AMCA's consolidated group for the years in which those five members posted positive separate taxable income.[2]

The parties have filed cross motions for summary judgment pursuant to Fed. R. Civ. P. 56. The parties agree that there are no genuine issues of material fact, and each believes that it is entitled to judgment as a matter of law.

I. FACTS

This tax dispute relates to the consolidated tax returns of UDI's corporate predecessor, AMCA International Corporation ("AMCA"). For each of the years between 1983 and 1986, AMCA was a member of a consolidated group that reported consolidated net operating losses of between $85 and $140 million. During that time, AMCA's consolidated return group included, among others, the following five corporations: Jesco, Inc. ("Jesco"), Cherry-Burrell Corporation ("Cherry-Burrell"); Amtel, Inc. ("Amtel"); The Litwin Corporation ("Litwin"); and Litwin Panamerican Corporation ("Panamerican").

AMCA acquired Jesco in 1978 and sold it to an unrelated purchaser in 1995. Between 1983 and 1986, Jesco reported positive separate taxable income. During those same years,

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2. All citations to the Internal Revenue Code and Treasury Regulations in this opinion shall refer to the versions of the Code and Regulations that were in effect between 1983 and 1986.

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Litwin recorded deductions attributable to product liability totalling $166,042 for 1993; $1,402,931 for 1994; $1,292,733 for 1995; and $127,682 for 1996.

AMCA formed Cherry-Burrell in September 1975 and liquidated it in 1991. Between 1983 and 1986, Cherry-Burrell reported positive separate taxable income. During those years. Cherry-Burrell also reported deductions attributable to product liability. Those losses totalled $34,608 in 1983; $192,287 in 1984; $8,642 in 1985; and $87,760 in 1986.

AMCA acquired Amtel in 1977. Amtel reported positive separate taxable income for 1984, 1985 and 1986, but not for 1983. Amtel recorded deductible product liability losses of $12,135 in 1984; $13,218 in 1985; and $7,549 in 1986.

Litwin was an Amtel subsidiary that joined the consolidated group when AMCA acquired Amtel in 1977. Litwin reported positive separate taxable income for 1983, 1985 and 1986, but not for 1984. Litwin's deductions attributable to product liability during that period were $5,250 in 1983; $4,198 in 1984; $14,139 in 1985; and $8,909 in 1986.

Panamerican was also an Amtel subsidiary that joined the consolidated group when AMCA acquired Amtel in 1977. Panamerican reported positive separate taxable income between 1983 and 1986. The company incurred deductible losses attributable to product liability of $19 in 1983; $1,987 in 1984; $5,056 in 1985; and $502 in 1986.

During 1986 and 1987, AMCA sought refunds based on Internal Revenue Code ("I.R.C." or "Code") § 172(b)(1)(I)

and Treas. Reg. § 1.1502-79(a)(3), claiming the 1983, 1984, 1985 and 1986 product liability losses of Jesco, Amtel, Litwin and Panamerican as ten-year carrybacks to the respective separate return years of each of these four companies. The Revenue Agent assigned to review those claims for refund determined that the losses in question could not be carried back to the separate return years of Jesco, Amtel, Litwin and Panamerican because, with the exception of Litwin in 1984, these companies each had positive separate taxable income for the years in which they incurred product liability losses.

The agent, however, treated AMCA's claims for refund as also claiming that the 1983, 1984, 1985 and 1986 product liability losses of Jesco, Amtel, Litwin and Panamerican were properly treated as part of AMCA's consolidated product liability losses for each of those years which could be carried back against AMCA's consolidated taxable income. Although the agent proposed to allow the carry backs to AMCA's consolidated return, the Joint Committee on Internal Revenue Taxation reviewed and reversed the agent's decision. AMCA also filed refund claims based on product liability losses that Cherry-Burrell incurred between 1983 and 1986; the agent proposed to allow those losses but was again reversed by the Joint Committee on Internal Revenue Taxation.

UDI thereafter brought this action, seeking a refund based on the product liability losses that it asserts it should have been permitted to carry back to its consolidated returns for 1973, 1974, 1975 and 1976.

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II. PARTIES' CONTENTIONS

A. Plaintiff's Motion for Summary Judgment

UDI contends that "[t]he only substantive issue in this case is the extent to which . . . the AMCA . . . consolidated group is entitled, under section 172(b)(1)(I) of the Internal Revenue Code of 1954 . . . to include in the 10 year carrybacks of its product liability losses incurred in the years 1983, 1984, 1985 and 1986 the deductions attributable to product liability of certain members of its group." Plaintiff's Brief at 1.

With respect to the product liability loss of a consolidated group, Plaintiff maintains that "[t]he only appropriate inquiry is whether the consolidated group has both a net operating loss and deductions attributable to product liability." Plaintiff's Brief at 9. That is, the appropriate assessment is not whether individual entities within the group post deductions attributable to product liability, but whether the consolidated group as a whole has done so. Thus, Plaintiff asserts that even if individual members of the consolidated group generated positive separate taxable income during the loss years at issue, the consolidated group may tally those companies' deductions attributable to product liability for the purpose of a ten-year carryback on the consolidated return.

According to UDI, the mechanics of the consolidated return regulations dictate that the product liability losses of a consolidated group be determined on a single entity basis. Under Reg. § 1.1502-12, each member of a consolidated

group computes its own separate taxable income. However, this computation does not take into account elements such as net operating loss carryovers, which Reg. § 1.1502-11 requires that taxpayers compute on a consolidated basis. The sole definition of a consolidated group's net operating loss appears at Reg. § 1.1502-21(f). That figure is determined by taking into account each entity's separate taxable income, with remaining items calculated on a consolidated basis only, wholly apart from separate taxable income. UDI thus concludes that a corporation that is a member of a consolidated group is incapable of having its own net operating loss under the consolidated return regulations. Because of this, UDI maintains that "simple logic compels the conclusion that the only manner in which section 172(j)(1) can be applied to a consolidated group is to compare its consolidated net operating loss with deductions attributable to product liability also calculated on a group wide basis." Plaintiff's Brief at 19. UDI also maintains that the single entity approach is required to apply all provisions of I.R.C. § 172 consistently.

B. Defendant's Motion for Summary Judgment

The United States contends that the interplay between section 172 and sections 1501 and 1502 dictate that summary judgment be entered in its favor. The United States maintains that product liability losses under section 172(j) must be computed separately for each member of a consolidated group. It further maintains that applying section 172(j) on a consolidated basis would conflict with the opinion in *Amtel, Inc. v. United States*, 31 Fed. Cl. 598 (1994), Treas Reg. § 1.1502-11, Treas. Reg. § 1.1502-79(a), and the language of section 172 itself.

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The United States maintains that the *Amtel* court specifically rejected Amtel's creation of a 'consolidated product liability loss deduction' because of the phrase's absence from the code and its regulations. 31 Fed. Cl. at 602. The United States declares that in this case, Plaintiff has merely changed the destination of the carry back at issue in *Amtel*, and that the theory and method rejected in *Amtel* are the same as those currently at issue.

According to the United States, allowing computation of the product liability loss deduction on a consolidated basis would conflict with Treas. Reg. § 1.1502-11 because it does not contain the concept of a "consolidated product liability loss deduction." The United States also notes that nothing in the consolidated return regulations provides for the computation of product liability deductions on a consolidated basis. Accordingly, the United States contends, a product liability loss as defined in section 172(j) can become part of a consolidated net operating loss only as a portion of the separate net operating losses of its members.

The United States contends that Treas. Reg. § 1.1502-79 is implicated in this case because some of the affiliated members of UDI's group of corporations that filed a consolidated return had separate return years for years to which the plaintiff's consolidated net operating loss could potentially be carried back. It declares that if Section 172(j) is applied on a consolidated basis, Treas. Reg. § 1.1502-79(a)(3) becomes unworkable. This is because an apportionment of a consolidated product liability loss results in member corporations with separate taxable income being apportioned part of the loss. However, the United States says,

only members with separate net operating losses are to be apportioned part of the loss.

The United States further argues that because deductions attributable to product liability do not exist on a consolidated level but do exist in the computation of separate taxable income or loss of a group's members, Section 172(j) must be applied only on the level of each separate member corporation.

III. ANALYSIS.

A. Jurisdiction

This Court has jurisdiction to hear tax refund suits under 28 U.S.C. § 1346(a)(1). However, the Internal Revenue Code provides a number of steps that a taxpayer must undertake within certain prescribed time periods before this Court may exercise jurisdiction under 28 U.S.C. § 1346(a)(1).

Under section 7422(a), Plaintiff must first have filed a claim for a refund before maintaining a refund suit. The statute of limitations for filing a claim for refund is three years from the time the return was filed or two years from payment of the tax. I.R.C. § 6511(a). An exception to the statute of limitations exists when a taxpayer agrees to an extension of the statute of limitations relating to the period during which a tax audit must be completed. I.R.C. § 6511(c)(1). Under the exception, "[t]he period for filing claim for credit or refund . . . shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement or any extension thereof under section 6501(c)(4)." *Id.*

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If a "claim or credit or refund relates to an overpayment attributable to a net operating loss carryback . . . the period [of limitations] shall be that period which ends 3 years after the time prescribed by law for filing the return (including extensions thereof) for the taxable year of the net operating loss . . . which results in such carryback, or the period prescribed in subsection (c) [relating to the exception to the general limitation period], whichever expires later . . . ." I.R.C. § 6511(d)(2)(A).

UDI entered into an agreement with the Internal Revenue Service ("IRS") to extend until June 30, 1994 the statute of limitations on assessment of tax by the IRS for the years December 31, 1982 through December 31, 1988. During 1986 and 1987, AMCA filed various claims for refund based on the product liability losses of the five member companies at issue in this litigation. All of these refund claims were filed within the statutorily allowable period.

Taxpayers may not bring refund suits "before the expiration of 6 months from the date of filing the claim of refund . . . nor after the expiration of 2 years from the date of mailing by certified mail or registered mail by the Secretary to the taxpayer of a notice of the disallowance." I.R.C. § 6532(a)(1). If a taxpayer files a written waiver of the requirement that the taxpayer be mailed a notice of disallowance, the 2 year limitation in section 6532(a)(1) begins on the date the waiver is filed. I.R.C. § 6532(a)(3). UDI met the first requirement of section 6532(a)(1) because it filed suit more than six months after it filed the required claims for refund. UDI also met the second requirement because it neither received statutory notice of a disallowance nor waived the right to receive such notice.

For the foregoing reasons, all jurisdictional requirements of the Code have been met and this Court has jurisdiction under 28 U.S.C. § 1346(a).

B. Summary Judgment Standard

Rule 56 of the Federal Rules of Civil Procedure directs that summary judgment be entered when a moving party shows "that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law." *Ross v. Communications Satellite Corp.*, 759 F.2d 355, 364 (4th Cir. 1985). The parties in this case agree that there are no factual disputes. Thus, the party entitled to judgment as a matter of law shall prevail on its motion for summary judgment.

C. Statutory Framework

The Internal Revenue Code provisions that, together with their regulations, address this case are 26 U.S.C. §§ 1501, 1502 and 172.

Section 1501 is among the provisions of the Code that exists for affiliated groups of corporations. Section 1501 allows affiliated groups that meet certain conditions to file consolidated returns. Neither party disputes that the AMCA group properly filed consolidated returns for the years at issue in this case.

Section 1502 authorizes the Secretary of the Treasury to promulgate regulations for groups of corporations filing consolidated returns. Under Reg. § 1.1502-2, the tax liability

of a consolidated group for a consolidated return year is determined by adding together a number of components, the first of which is "the tax imposed by section 11 [of the Code] on the consolidated taxable income for such year."

Consolidated taxable income for a consolidated return year is determined under Treas. Reg. § 1.1502-11 by taking into account eight separate items. The first of these is "[t]he separate taxable income of each member of the group." Reg. § 1.1502-11. Separate taxable income, which is computed pursuant to Reg. § 1.1502-12, "is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to several modifications. Treas. Reg. § 1.1502-12. One of those modifications states that "[n]o net operating loss deduction shall be taken into account." Treas. Reg. § 1.1502-12(h). A net operating loss deduction is the sum of the net operating loss carryovers and carrybacks to a given tax year. I.R.C. § 172(a). The parties agree that for the years in dispute, the group members at issue (with the exception of Amtel in 1983 and Litwin in 1984) posted positive separate taxable income pursuant to these calculations.

Net operating losses are the subject of section 172. Under section 172, taxpayers may generally carry back net operating losses for three years preceding the taxable year in which they incurred the losses. The section contains an exception for product liability losses sustained in taxable years beginning after September 20, 1979. That exception provides that "[i]n the case of a taxpayer which has a product liability loss . . . , the product liability loss shall be a net operating loss carry back to each of the 10 taxable years preceding the

loss year." I.R.C. § 172(b)(1)(I) This exception applies to the product liability losses for each of the loss years in dispute in this case.

The Code defines "product liability loss" as the lesser of a net operating loss or "the sum of the amounts allowable as deductions under sections 162 and 165 which are attributable to (i) product liability, or (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability." I.R.C. § 172(j)(1). Under this definition, a company's product liability loss is merely a subset of its net operating loss. Thus, it is the portion of a company's net operating loss that is attributable to product liability that companies may carry back for the extended ten-year period.

If the composition of a consolidated group remained constant over a decade, the consolidated group's net operating losses (including the portion that constitutes its product liability loss) could be carried back on a consolidated basis to offset the group's aggregate taxable income. Further, no apportionment need occur if there is involved "a prior separate return year for which such member was not in existence and shall be included in the consolidated net operating loss carrybacks to the equivalent consolidated return year of the group . . . provided that such member was a member of the group immediately after its organization." Treas. Reg. 1.1502-79(a)(2). Because Cherry-Burrell was part of the consolidated group immediately after its incorporation in 1975, its product liability losses for 1985 and 1986 should be considered wholly on a consolidated basis. Thus, its product liability loss should be compared to

the AMCA group's net operating loss. Because Cherry-Burrell's product liability losses are smaller than the group's net operating losses, UDI is entitled to a refund representing the ten-year carrybacks from Cherry-Burrell's 1985 and 1986 product liability losses.[3]

Most of the members of the consolidated group in the case at bar did not remain constant over the relevant decade. The deductions at the center of this dispute arose between 1983 and 1986. Because section 172 allows ten-year carrybacks for product liability losses, the losses could be carried back to years between 1973 and 1976. In 1973 and 1974, none of the five member companies that generated the product liability losses were members of AMCA's consolidated group. In 1975 and 1976, all of the companies at issue in this litigation except Cherry-Burrell filed separate returns.

"[A] taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group" constitutes a separate return year. Treas. Reg. § 1.1502-1(e). When separate return years are at issue, apportionment rules must be used to

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3. The holding in *Amorient, Inc. v. Commissioner*, 103 T.C. 161 (1994), does not preclude this result. *Amorient* holds that a consolidated group cannot carry back to a consolidated return of the same consolidated group any part of a net operating loss that Treas. Reg. § 1.1502-79(a)(1) requires be carried back to a separate return year. In this case, the no net operating losses or product liability losses are allowed to be carried back to separate return years. Therefore, no losses are deducted from the those that may be carried back to consolidated returns.

determine the portion of the consolidated net operating losses that should not involved in computation of the consolidated group's taxable income. Specifically, the apportionment regulation is invoked when "a consolidated net operating loss can be carried under the principles of section 172(b) . . . to the separate return years of a corporation." Treas. Reg. § 1.1502-79(a)(1)(i). This case involves product liability losses. Because the Code permits a company to carry back these losses ten years, they can be carried to separate return years of the five group members that are central to this litigation. Thus, the facts of this case fall among situations to which Treas. Reg. § 1.1502-79 applies. That regulation requires that if a loss can be apportioned, then it shall be considered a net operating loss carryover or carryforward to the separate return year. *Id.* Any loss that is considered a carryover to a separate return year is thereafter not eligible to "be included in the consolidated net operating loss carryovers . . . to the equivalent consolidated return year." *Id.*

When consolidated net operating losses are apportioned, then so too must be the subset that constitutes product liability losses. The definition of a product liability loss must then be applied to the apportioned amounts. The lesser of a company's net operating loss or its deductions attributable to product liability — a product liability loss as defined under section 172(j)(1) — is zero for the years in which a company had positive separate taxable income. Therefore, none of the net operating loss may be carried back for 10 years as a product liability loss to the separate return years of each of the companies that posted taxable income. Similarly, none of the net operating loss is eligible to be included in the

carryovers to the equivalent consolidated return year. Because none of the product liability loss is excluded from use on the consolidated group's return, the product liability loss may be compared to the remainder of the group's net operating losses. If the group's net operating losses total more than the product liability losses not apportioned to separate returns — which, in this case, would be all of the deductions attributable to product liability sustained in the loss years at issue — then the entire product liability loss may be carried back the full ten years to the group's consolidated return. This result is unsurprising. As Plaintiff notes in its brief: "This is a simple, plain vanilla case, involving only a single consolidated group and its effort to carry a net operating loss from one consolidated return year to another consolidated return year of the same group."

D. Collateral Estoppel

The United States asserts that allowing consideration of section 172 on a consolidated basis would conflict with the decision rendered in *Amtel v. United States*, 31 Fed. Cl. 598 (1994). *Amtel* involved product liability deductions of the same consolidated taxpayer at issue in this case. *Amtel* arose because the taxpayer sought to carry back to a separate return year a product liability loss from a consolidated return year. At issue in that case was tax year 1985, for which the corporation had a consolidated net operating loss of $85.5 million, with $6.1 million in deductions attributable to product liability. Although group member Amtel generated positive separate taxable income, the company sought to carry back the product liability losses 10 years to a separate return year.

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The *Amtel* court disallowed any refund for a carry back of a product liability deduction for Amtel because of the separate return year, which changed the nature of the treatment of the consolidated group's net operating loss. As the *Amtel* court said, "[t]he term 'net operating loss' in the context of a consolidated income tax return generally means the net operating loss of the consolidated group as a whole, and not the separate net operating loss of a member." *Amtel*, 31 Fed. Cl. at 600. However, "[t]he IRS does not apply the single entity approach when a taxpayer seeks to carry back a net operating loss from a consolidated return year to a separate return year. In that context, the Service treats members as separate by apportioning the consolidated net operating loss." *Id.*

Because Amtel's net operating loss had to be apportioned, its product liability loss under Section 172(j)(1) was limited to its own 1985 net operating loss, which was zero. In so holding, the court rejected Amtel's argument that only the group's consolidated net operating loss and aggregate product liability deductions should be compared. The court stated that the "regulations do not use the term 'product liability loss' or incorporate such a concept by directing that product liability loss be treated on a consolidated basis." 31 Fed. Cl. at 602.

Amtel neither governs nor collaterally estops prosecution of this case. In *Amtel*, the question was whether losses might be carried back to a separate return year. The court in that case rejected the notion of a "consolidated" product liability loss only to the extent that such a loss was an attempt to supersede the individual tax attributes of a member company for a separate return year.

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IT IS THEREFORE ORDERED that

(1) the United States shall allow UDI to carry back ten years to its consolidated returns the product liability losses at issue in this case;

(2) UDI and the United States shall recompute and reconfirm the total deductions allowed and the amount of the refund due UDI and within 30 days shall report that amount to the Court so that the Court may issue a final judgment in this case; and

(3) upon entry of a final judgment, the United States shall refund to UDI the total deductions computed in accordance with this Order.

This 19th day of June, 1998.

s/ Graham C. Mullen
THE UNITED STATES
DISTRICT JUDGE
GRAHAM C. MULLEN

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DENYING PETITION FOR REHEARING DATED AND FILED MAY 19, 2000

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 98-2380
CA-95-341-MU

UNITED DOMINION INDUSTRIES,
INCORPORATED

Plaintiff – Appellee

v.

UNITED STATES OF AMERICA

Defendant – Appellant

On Petition for Rehearing and Rehearing En Banc

The appellee's petition for rehearing and rehearing en banc was submitted to this Court. As no member of this Court or the panel requested a poll on the petition for reheating en banc, and

As the panel considered the petition for rehearing and is of the opinion that it should be denied,

IT IS ORDERED that the petition for rehearing and rehearing en banc is denied.

For the Court,

/s/ Patricia S. Connor
CLERK

APPENDIX D — REGULATIONS INVOLVED

26 C.F.R. § 1.1502-1 (1986)

§ 1.1502-1. **Definitions.** — (a) *Group.* The term "group" means an affiliated group of corporations as defined in section 1504. See § 1.1502-75(d) as to when a group remains in existence.

(b) *Member.* The term "member" means a corporation (including the common parent) which is included within such group.

(c) *Subsidiary.* The term "subsidiary" means a corporation other than the common parent which is a member of such group.

(d) *Consolidated return year.* The term "consolidated return year" means a taxable year for which a consolidated return is filed or required to be filed by such group.

(e) *Separate return year.* The term "separate return year" means a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group.

(f) *Separate return limitation year* — (1) *In general.* Except as provided in subparagraphs (2) and (3) of this paragraph, the term "separate return limitation year" means any separate return year of a member or of a predecessor of such member. The term "predecessor" means a transferor or distributor of assets to a member in a transaction to which section 381(a) applies.

(2) *Exceptions.* The term "separate return limitation year" shall not include —

(i) A separate return year of the corporation which is the common parent for the consolidated return year to which the tax attribute is to be carried (except as provided in § 1.1502-75(d)(2)(ii) and subparagraph (3) of this paragraph),

(ii) A separate return year of any corporation which was a member of the group for each day of such year, or

(iii) A separate return year of a predecessor of any member if such predecessor was a member of the group for each day of such year,

provided that an election under section 1562(a) (relating to the privilege to elect multiple surtax exemptions) was never effective (or is no longer effective as a result of a termination of such election) for such year. An election under section 1562(a) which is effective for a taxable year beginning in 1963 and ending in 1964 shall be disregarded.

* * *

26 C.F.R. § 1.1502-11 (1986)

§ 1.1502-11. **Consolidated taxable income.** — (a) *In general.* The consolidated taxable income for a consolidated return year shall be determined by taking into account —

(1) The separate taxable income of each member of the group (see § 1.1502-12 for the computation of separate taxable income);

(2) Any consolidated net operating loss deduction (see § 1.1502-21 for the computation of the consolidated net operating loss deduction);

(3) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (see § 1.1502-22 for the computation of the consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977));

(4) Any consolidated section 1231 net loss (see § 1.1502-23 for the computation of the consolidated section 1231 net loss);

(5) Any consolidated charitable contributions deduction (see § 1.1502-24 for the computation of the consolidated charitable contributions deduction);

(6) Any consolidated section 922 deduction (see § 1.1502-25 for the computation of the consolidated section 922 deduction);

(7) Any consolidated dividends received deduction (see § 1.1502-26 for the computation of the consolidated dividends received deduction); and

(8) Any consolidated section 247 deduction (see § 1.1502-27 for the computation of the consolidated section 247 deduction).

* * *

Appendix D

26 C.F.R. § 1.1502-12 (1986)

§ 1.1502-12. **Separate taxable income.** — The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to the following modifications:

(a) Transactions between members and transactions with respect to stock, bonds, or other obligations of members shall be reflected according to the provisions of §§ 1.1502-13 and 1.1502-14;

(b) Any deduction which is disallowed under § 1.1502-15 shall be taken into account as provided in that section;

(c) The limitation on deductions provided in section 615(c) or section 617(h) shall be taken into account as provided in § 1.1502-16;

(d) The method of accounting under which such computation is made and the adjustments to be made because of any change in method of accounting shall be determined under § 1.1502-17;

(e) Inventory adjustments shall be made as provided in § 1.1502-18;

(f) Any amount included in income under § 1.1502-19 shall be taken into account;

(g) In the computation of the deduction under section 167, property shall not lose its character as new property as a result of a transfer from one member to another member during a consolidated return year if —

(1) The transfer occurs on or before January 4, 1973, or

(2) The transfer occurs after January 4, 1973, and the transfer is a deferred intercompany transaction as defined in § 1.1502-13(a)(2) or the basis of the property in the hands of the transferee is determined (in whole or in part) by reference to its basis in the hands of the transferor;

(h) No net operating loss deduction shall be taken into account;

(i) [Reserved]

(j) No capital gains or losses shall be taken into account;

(k) No gains and losses subject to section 1231 shall be taken into account;

(l) No deduction under section 170 with respect to charitable contributions shall be taken into account;

(m) No deduction under section 922 (relating to the deduction for Western Hemisphere trade corporations) shall be taken into account;

(n) No deductions under section 243(a)(1), 244(a), 245, or 247 (relating to deductions with respect to dividends received and dividends paid) shall be taken into account;

(o) Basis shall be determined under §§ 1.1502-31 and 1.1502-32, and earnings and profits shall be determined under § 1.1502-33; and

(p) The limitation on deductions provided in section 613A shall be taken into account for each member's oil and gas properties as provided in § 1.1502-44.

(q) A thrift institution's deduction under section 593(b)(2) (relating to the addition to the reserve for bad debts of a thrift institution under the percentage of taxable income method) shall be determined under § 1.1502-42.

The term "separate taxable income" shall include a case in which the determination under this section results in an excess of deductions over gross income.

26 C.F.R. § 1.1502-21 (1986)

§ 1.1502-21. **Consolidated net operating loss deduction.** — (a) *In general.* The consolidated net operating loss deduction shall be an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year (as determined under paragraph (b) of this section).

(b) *Consolidated net operating loss carryovers and carrybacks* — (1) *In general.* The consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the

group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b). However, such consolidated carryovers and carrybacks shall not include any consolidated net operating loss apportioned to a corporation for a separate return year pursuant to paragraph (a) of § 1.1502-79, and shall be subject to the limitations contained in paragraphs (c), (d), and (e) of this section and to the limitation contained in § 1.1502-15.

* * *

(3) *Absorption rules.* For purposes of determining the amount, if any, of a net operating loss (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such net operating loss which is absorbed in a prior consolidated return year under section 172(b)(2) shall be determined by —

(i) Applying all net operating losses which can be carried to such prior year in the order of the taxable years in which such losses were sustained, beginning with the taxable year which ends earliest, and

(ii) Applying all such losses which can be carried to such prior year from taxable years ending on the same date on a pro rata basis, except that any portion of a net operating loss attributable to a foreign expropriation loss to which section 172(b)(1)(D) applies shall be applied last.

(c) *Limitation on net operating loss carryovers and carrybacks from separate return limitation years* — (1) *General rule.* In the case of a net operating loss of a

member of the group arising in a separate return limitation year (as defined in paragraph (f) of § 1.1502-1) of such member (and in a separate return limitation year of any predecessor of such member), the amount which may be included under paragraph (b) of this section (computed without regard to the limitation contained in paragraph (d) of this section) in the consolidated net operating loss carryovers and carrybacks to a consolidated return year of the group shall not exceed the amount determined under subparagraph (2) of this paragraph.

(2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of —

(i) Consolidated taxable income (computed without regard to the consolidated net operating loss deduction), minus such consolidated taxable income recomputed by excluding the items of income and deduction of such member, over

(ii) The net operating losses attributable to such member which may be carried to the consolidated return year arising in taxable years ending prior to the particular separate return limitation year.

(3) *Examples.* The provisions of this paragraph and paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). (i) Corporation P formed corporations S and T on January 1, 1965. P, S, and T filed separate returns

for the calendar year 1965, a year for which an election under section 1562 was effective. T's return for that year reflected a net operating loss of $10,000. The group filed a consolidated return for 1966 reflecting consolidated taxable income of $30,000 (computed without regard to the consolidated net operating loss deduction). Among the transactions occurring during 1966 were the following:

(*a*) P sold goods to T deriving deferred profits of $7,000 on such sales, $2,000 of which was restored to consolidated taxable income on the sale of such goods to outsiders:

(*b*) T sold a machine to S deriving a deferred profit of $5,000, $1,000 of which was restored to consolidated taxable income as a result of S's depreciation deductions;

(*c*) T distributed a $3,000 dividend to P; and

(*d*) In addition to the transactions described above, T had other taxable income of $6,000.

(ii) The carryover of T's 1965 net operating loss to 1966 is subject to the limitation contained in this paragraph, since 1965 was a separate return limitation year (an election under section 1562 was effective for such year). Thus, only $7,000 of T's $10,000 net operating loss is a consolidated net operating loss carryover to 1966, since such carryover is limited to consolidated taxable income (computed without regard to the consolidated net operating loss deduction), $30,000, minus such consolidated taxable income recomputed by excluding the items of income and deduction of T, $23,000 (*i.e.*, consolidated taxable income computed

without regard to the $1,000 restoration of T's deferred gain and T's $6,000 of other income). In making such recomputation, no change is made in the effect on consolidated taxable income of P's sale to T,, or of the dividend from T to P.

Example (2). (i) Corporation P was formed on January 1, 1966. P filed separate returns for the calendar years 1966 and 1967 reflecting net operating losses of $4,000 and $12,000, respectively. P purchased corporation S on March 15, 1967. S was formed on February 1, 1966, and filed a separate return for the taxable year ending January 31, 1967. S also filed a short period return for the period from February 1 to December 31, 1967, and joined with P in filing a consolidated return for 1968. S sustained net operating losses of $5,000 and $6,000 for its taxable years ending January 31, 1967 and December 31, 1967, respectively. An election under section 1562 was not effective for P and S during the period involved. Consolidated taxable income for 1968 (computed without regard to the consolidated net operating loss deduction) was $16,000; such consolidated taxable income recomputed by disregarding the items of income and deduction of S was $9,000.

(ii) In order of time, the following losses are absorbed in 1968:

(*a*) P's $4,000 net operating loss for the calendar year 1966 (such loss is not subject to the limitation contained in this paragraph since P is the common parent corporation for 1968);

(*b*) S's $5,000 net operating loss for the year ended January 31, 1967. Such loss is subject to the limitation contained in this paragraph, since S was not a member of the group on each day of such year. However, such loss can be carried over and absorbed in full since such limitation is $7,000 (consolidated taxable income computed without regard to the consolidated net operating loss deduction, $16,000, minus such consolidated taxable income recomputed, $9,000); and

(*c*) $6,000 of P's net operating loss and $1,000 of S's net operating loss for the taxable years ending December 31, 1967. This is determined by applying the losses from such year which can be carried to 1968 (P's $12,000 loss and $2,000 of S's $6,000 loss, since such $6,000 loss is limited under this paragraph) on a pro rata basis against the amount of such losses which can be absorbed in that year, $7,000 (consolidated taxable income of $16,000 less the $9,000 of losses absorbed from prior years). The carryover of S's loss to 1968 is subject to the limitation contained in that paragraph, since S was not a member of the group on each day of its taxable year ending December 31, 1967. Such loss is limited to $2,000, the excess of $7,000 (as determined under (ii)(*b*)) over $5,000 (S's carryover from the year ended January 31, 1967). If a consolidated return is filed in 1969, the consolidated net operating loss carryovers will consist of P's unabsorbed loss of $6,000 ($12,000 minus $6,000) from 1967 and, subject to the limitation contained in this paragraph, S's unabsorbed loss of $5,000 ($6,000 minus $1,000) from its year ended December 31, 1967.

* * *

(f) *Consolidated net operating loss.* The consolidated net operating loss shall be determined by taking into account the following:

(1) The separate taxable income (as determined under § 1.1502-12) of each member of the group, computed without regard to any deduction under section 242;

(2) Any consolidated capital gain net income (net capital gain for taxable years beginning before January 1, 1977);

(3) Any consolidated section 1231 net loss;

(4) Any consolidated charitable contributions deduction;

(5) Any consolidated dividends received deduction (determined under § 1.1502-26 without regard to paragraph (a)(2) of that section); and

(6) Any consolidated section 247 deduction (determined under § 1.1502-27 without regard to paragraph (a)(1)(ii) of that section).

26 C.F.R. § 1.1502-75 (1986)

§ 1.1502-75. **Filing of consolidated returns.** — (a) *Privilege of filing consolidated returns* — (1) *Exercise of privilege for first consolidated return year.* A group which did not file a consolidated return for the immediately preceding taxable year may file a consolidated return in lieu of separate returns for the taxable year, provided that each

corporation which has been a member during any part of the taxable year for which the consolidated return is to be filed consents (in the manner provided in paragraph (b) of this section) to the regulations under section 1502. If a group wishes to exercise its privilege of filing a consolidated return, such consolidated return must be filed not later than the last day prescribed by law (including extensions of time) for the filing of the common parent's return. Such consolidated return may not be withdrawn after such last day (but the group may change the basis of its return at any time prior to such last day).

(2) *Continued filing requirement.* A group which filed (or was required to file) a consolidated return for the immediately preceding taxable year is required to file a consolidated return for the taxable year unless it has an election to discontinue filing consolidated returns under paragraph (c) of this section.

* * *

26 C.F.R. § 1.1502-79 (1986)

§ 1.1502-79. **Separate return years.** — (a) *Carryover and carryback of consolidated net operating losses to separate return years.* — (1) *In general.* If a consolidated net operating loss can be carried under the principles of section 172(b) and paragraph (b) of § 1.1502-21 to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member in the year in which such loss arose, then the portion of such consolidated net operating loss attributable to such

corporation (as determined under subparagraph (3) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) and shall be a net operating loss carryover or carryback to such separate return year; accordingly, such portion shall not be included in the consolidated net operating loss carryovers or carrybacks to the equivalent consolidated return year. Thus, for example, if a member filed a separate return for the third year preceding a consolidated return year in which a consolidated net operating loss was sustained and if any portion of such loss is apportioned to such member for such separate return year, such portion may not be carried back by the group to its third year preceding such consolidated return year.

(ii) If a corporation ceases to be a member during a consolidated return year, any consolidated net operating loss carryover from a prior taxable year must first be carried to such consolidated return year, notwithstanding that all or a portion of the consolidated net operating loss giving rise to the carryover is attributable to the corporation which ceases to be a member. To the extent not absorbed in such consolidated return year, the portion of the consolidated net operating loss attributable to the corporation ceasing to be a member shall then be carried to such corporation's first separate return year.

(2) *Nonapportionment to certain members not in existence.* Notwithstanding subparagraph (1) of this paragraph, the portion of a consolidated net operating loss attributable to a member shall not be apportioned to a prior separate return year for which such member was not in

existence and shall be included in the consolidated net operating loss carrybacks to the equivalent consolidated return year of the group (or, if such equivalent year is a separate return year, then to such separate return year), provided that such member was a member of the group immediately after its organization.

(3) *Portion of consolidated net operating loss attributable to a member.* The portion of a consolidated net operating loss attributable to a member of a group is an amount equal to the consolidated net operating loss multiplied by a fraction, the numerator of which is the separate net operating loss of such corporation, and the denominator of which is the sum of the separate net operating losses of all members of the group in such year having such losses. For purposes of this subparagraph, the separate net operating loss of a member of the group shall be determined under § 1.1502-12 (except that no deduction shall be allowed under section 242), adjusted for the following items taken into account in the computation of the consolidated net operating loss:

(i) The portion of the consolidated dividends received deduction, the consolidated charitable contributions deductions, and the consolidated section 247 deduction, attributable to such member;

(ii) Such member's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) (determined without regard to any net capital loss carryover attributable to such member);

(iii) Such member's net capital loss and section 1231 net loss, reduced by the portion of the consolidated net capital loss attributable to such member (as determined under paragraph (b)(2) of this section); and

(iv) The portion of any consolidated net capital loss carryover attributable to such member which is absorbed in the taxable year.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation P was formed on January 1, 1966. P filed a separate return for the calendar year 1966. On March 15, 1967, P formed corporation S. P and S filed a consolidated return for 1967. On January 1, 1968, P purchased all the stock of corporation T, which had been formed in 1967 and had filed a separate return for its taxable year ending December 31, 1967.

(ii) P, S, and T join in the filing of a consolidated return for 1968, which return reflects a consolidated net operating loss of $11,000. $2,000 of such consolidated net operating loss is attributable to P, $3,000 to S, and $6,000 to T. Such apportionment of the consolidated net operating loss was made on the basis of the separate net operating losses of each member as determined under subparagraph (3) of this paragraph.

(iii) $5,000 of the 1968 consolidated net operating loss can be carried back to P's separate return for 1966. Such amount is the portion of the consolidated net operating loss

attributable to P and S. Even though S was not in existence in 1966, the portion attributable to S can be carried back to P's separate return year, since S (unlike T) was a member of the group immediately after its organization. The 1968 consolidated net operating loss can be carried back against the group's income in 1967 except to the extent (*i.e.*, $6,000) that it is apportioned to T for its 1967 separate return year and to the extent that it was absorbed in P's 1966 separate return year. The portion of the 1968 consolidated net operating loss attributable to T ($6,000) is a net operating loss carryback to its 1967 separate return.

Example (2). (i) Assume the same facts as in example (1). Assume further that on June 15, 1969, P sells all the stock of T to an outsider, that P and S file a consolidated return for 1969 (which includes the income of T for the period January 1 through June 15), and that T files a separate return for the period June 16 through December 31, 1969.

(ii) The 1968 consolidated net operating loss, to the extent not absorbed in prior years, must first be carried to the consolidated return year 1969. Any portion of the $6,000 amount attributable to T which is not absorbed in T's 1967 separate return year or in the 1969 consolidated return year shall then be carried to T's separate return year ending December 31, 1969.

* * * *

APPENDIX E — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT IN *INTERMET CORPORATION & SUBSIDIARIES v. COMMISSIONER OF INTERNAL REVENUE* DATED, DECIDED AND FILED APRIL 20, 2000

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 99-1046

INTERMET CORPORATION & SUBSIDIARIES,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On Appeal from the United States Tax Court.
No. 8246-97 — Thomas B. Wells, Tax Court Judge.

Argued: December 6, 1999

Decided and Filed: April 20, 2000

Before: RYAN and SUHRHEINRICH, Circuit Judges; BELL, District Judge.*

* * *

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* The Honorable Robert Holmes Bell, United States District Judge for the Western District of Michigan, sitting by designation.

Appendix E

OPINION

RYAN, Circuit Judge. This case requires us to decide whether an affiliated group of corporations filing a consolidated federal income tax return is entitled to a 10-year carryback for certain "specified liability" expenses incurred by a member corporation with positive separate taxable income. We conclude that the 10-year carryback is applicable under this scenario. Therefore, we will REVERSE the judgment of the United States Tax Court and REMAND to that court for further proceedings consistent with this opinion.

I.

The relevant facts are undisputed. Intermet Corporation is the common parent of an affiliated group of corporations that manufactures precision iron castings for automotive and industrial equipment producers. The group filed consolidated federal income tax returns for calendar years 1984 through 1992. The group's members used the accrual method of accounting for both financial accounting and federal income tax purposes during this time period.

Intermet claimed that in 1992 it incurred certain "specified liability" (SL) expenses attributable to several member corporations. At issue in this appeal are certain claimed SL expenses incurred by Lynchburg Foundry Co., a member of the group between 1984 and 1992. Lynchburg's claimed SL expenses in 1992 consisted of: (1) $717,617 (plus $299,412.63 in interest) to cover its Michigan Single Business Tax liability for 1986, 1987, and 1988; and (2) interest on its 1987 federal income tax liability in the amount of $2,175.60.

Appendix E

In 1992, Lynchburg had a positive "separate taxable income" (STI), as defined under the Treasury Regulations, of $3,940,085. The STI was positive because Lynchburg's gross income exceeded its deductions. Lynchburg deducted its claimed SL expenses in calculating its 1992 STI. On the other hand, Intermet had a $25,701,038 "consolidated net operating loss" (CNOL) under the Treasury Regulations in 1992, far exceeding Lynchburg's claimed SL expenses.

In 1994, Intermet filed an amended income tax return to carry back to 1984 the claimed SL expenses incurred by Lynchburg during 1992. Intermet claimed this carryback on the ground that the expenses qualified for the 10-year carryback provision for "specified liability loss" (SLL) deductions under the Internal Revenue Code. On March 14, 1997, the IRS issued a notice of deficiency for calendar year 1984, disallowing the carryback. Intermet filed a petition in the United States Tax Court contesting the deficiency determination.

The case was submitted to the Tax Court on a fully stipulated record, presenting the following issues: (1) whether the claimed SL expenses fit the statutory definition of a SLL under I.R.C. § 172(f)(1)(B) (1994) (amended in 1998); and (2) whether Intermet could take advantage of the SLL 10-year carryback where the group had a CNOL but the member that incurred the SL expenses had a positive STI. The Tax Court held in favor of the IRS on issue two, and did not reach the first issue. *Intermet Corp. & Subsidiaries v. Commissioner*, 111 T.C. 294 (1998).

The Tax Court reasoned that Lynchburg's SL expenses did not qualify for the SLL carryback because they were not

"taken into account" in computing Intermet's net operating loss (NOL) for 1992, as required by the Internal Revenue Code. *Id.* at 304-05. The court first noted that Lynchburg had no separate or individual NOL in 1992 because its gross income exceeded allowable deductions. *Id.* at 300. The Tax Court then proceeded to determine whether Lynchburg's SL expenses were "taken into account" in computing Intermet's CNOL. Relying on the Treasury Regulations, the court concluded that they were not. *Id.* at 301-03.

The court correctly noted that the consolidated return regulations do not treat members' SL expenses on a consolidated basis for purposes of calculating a group's CNOL. Instead, SL expenses are netted against a member's income in computing a member's STI, which is then used to calculate the group's CNOL. Based upon these regulations, the Tax Court reasoned an SL expense is "absorbed" by a group member's current income in computing the member's positive STI, and the "exhausted" expenses cannot be used by the group or parent for purposes of the 10-year SLL carryback. *Id.* at 302.

Intermet timely appealed the Tax Court's judgment, maintaining that it satisfied the statutory requirements for the SLL carryback. Specifically, Intermet contends that Lynchburg's SL expenses were "taken into account" in calculating Intermet's CNOL because the expenses were used in calculating Lynchburg's STI which, in turn, was used to calculate Intermet's CNOL. It makes no difference, Intermet agrees, whether Lynchburg's STI was positive or negative because Lynchburg's SL expenses would have a direct, dollar-for-dollar impact on both Lynchburg's STI and Intermet's CNOL in either event.

II.

Since the facts are undisputed and this case presents a pure question of law, we review the Tax Court's judgment *de novo*. *Estate of Mueller v. Commissioner*, 153 F.3d 302, 304 (6th Cir. 1998), *cert. denied*, 525 U.S. 1140 (1999). Statutory "provisions granting a [tax] deduction . . . are matters of legislative 'grace' and are construed strictly (in favor of the government)." *Weingarden v. Commissioner*, 825 F.2d 1027, 1029 (6th Cir. 1987). The taxpayer bears the burden of pointing to a clear provision entitling it to a claimed deduction. *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

Where an agency regulation interprets an ambiguous statutory provision, we limit our review to whether the regulation is a reasonable, but not necessarily the best, interpretation. *Atlantic Mut. Ins. Co. v. Commissioner*, 523 U.S. 382, __, 118 S. Ct. 1413, 1418 (1998). An agency's interpretation of its own ambiguous regulation also deserves substantial deference if the interpretation is reasonable insofar as it " 'sensibly conforms to the purpose and wording of the regulations.' " *Martin v. Occupational Safety and Health Review Comm'n*, 499 U.S. 144, 151 (1991) (quoting *Northern Indiana Pub. Serv. Co. v. Porter Cty. Chapter of Izaak Walton League of Am., Inc.*, 423 U.S. 12, 15 (1975)). *See also Martin v. American Cyanamid Co.*, 5 F.3d 140, 144 (6th Cir. 1993).

III.

This case presents a straightforward issue, but one that arises in the context of a complex regulatory framework.

We therefore proceed to summarize that framework as it existed in 1992, the relevant year here.

The Internal Revenue Code permits a taxpayer to carry an NOL forward to future taxable years or back to preceding taxable years to offset taxable income generated in those years, yielding a tax refund. I.R.C. § 172(b) (1994). This provision " 'permit[s] a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year.' " *Six Seam Co. v. United States*, 524 F.2d 347, 351 (6th Cir. 1975) (quoting *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957)). In 1992, the general carryback period was three years preceding the year in which the NOL was incurred. I.R.C. § 172(b)(1)(A)(i) (1994) (amended in 1997). In 1997, the three-year carryback was reduced to two years.

The Code extends the carryback period to 10 years for certain "specified liability losses." *Id.* § 172(b)(1)(C) (1994). A transition rule enacted in 1990 prohibits the SLL carryback to years preceding 1984. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11811(b)(2)(B), 104 Stat. 1388 (1990).

As of 1992, the Code defined SLL as follows:

> **(1) In general.** — The term "specified liability loss" means the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year:
>
> . . .

> **(B)** Any amount . . . allowable as a deduction under this chapter with respect to a liability which arises under a Federal or State law . . . if —
>
> > **(i)** In the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year . . . .
>
> A liability shall not be taken into account under subparagraph (B) unless the taxpayer used an accrual method of accounting throughout the period or periods during which the acts or failures to act giving rise to such liability occurred.
>
> **(2) Limitation.** — The amount of the specified liability loss for any taxable year shall not exceed the amount of the net operating loss for such taxable year.

I.R.C. § 172(f) (1994) (amended in 1998). Thus, a taxpayer is entitled to the SLL carryback if, among other things: (1) SL expenses as defined under section 172(f)(1)(B) exist; (2) the taxpayer has an NOL for the year; (3) the SL expenses are "taken into account" in calculating the NOL; and (4) the SLL carryback does not exceed the NOL for the year.

The Code permits an affiliated group of corporations to file a consolidated return in lieu of separate income tax

returns. It does not address whether, or how, the SLL carryback provision applies in the consolidated return context. Rather, the Code delegates to the Secretary of the Treasury broad authority to prescribe regulations

> as he may deem necessary in order that the tax liability of any affiliated group of corporations . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

Id. § 1502. To file a consolidated return, all member organizations must agree to comply with the consolidated return regulations. *Id.* § 1501. Among the advantages of consolidated returns are the ability to offset gains and losses of group members and "greater utilization of NOL . . . carryovers." *Wolter Constr. Co. v. Commissioner*, 634 F.2d 1029, 1031 n.1 (6th Cir. 1980).

The Treasury Regulations comprise "the bulk of the 'law' " addressing consolidated returns. *Id.* at 1032. Unfortunately, the regulations do not specifically address the application of the SLL carryback. They do establish a default rule that "[t]he Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application." Treas. Reg. § 1.1502-80(a) (as amended in 1997).

To determine the tax liability of an affiliated group under the regulations, it is first necessary to determine the

consolidated taxable income for the group. *Id.* § 1.1502-2(a) (as amended in 1996). Consolidated taxable income is determined under Treas. Reg. § 1.1502-11(a) (as amended in 1997) by taking into account the following items:

> 1. The STI of each group member; and
>
> 2. The following "consolidated" items: (a) the consolidated net operating loss deduction; (b) consolidated capital gain net income; (c) consolidated section 1231 net loss; (d) consolidated charitable contributions deduction; (e) consolidated section 922 deduction; (f) consolidated dividends received deduction; and (g) consolidated section 247 deduction.

A member's STI — which encompasses cases in which deductions exceed gross income (negative STI) and vice versa (positive STI) — is calculated pursuant to Treas. Reg. § 1.1502-12 (as amended in 1996). Each member computes its STI in a manner similar to a separate corporation computing taxable income, but with a number of modifications. For example, a member does not take into account the consolidated items specified in Treas. Reg. § 1.1501-11. *Id.* § 1.1502-12(h)-(n).

Section 1.1502-21A defines the CNOL deduction, one of the consolidated items to be taken into account in calculating taxable income, as the aggregate of the CNOL carryovers and carrybacks to the taxable year. *Id.* § 1.1502-21A(a) (as redesignated and amended by T.D. 8677, 1996-30 I.R.B. 7, 1996-2 C.B. 119). The aggregate carryovers and

carrybacks consist of the group's CNOLs that may be carried back or over to the taxable year pursuant to I.R.C. § 172(b). *Id.* § 1.1502-21A(b)(1). The group's CNOL is calculated in a manner analogous to computing consolidated taxable income, taking into account: (1) the STI of each group member; (2) consolidated capital gain net income; (3) consolidated section 1231 net loss; (4) consolidated charitable contributions deduction; (5) consolidated dividends received deduction; and (6) consolidated section 247 deduction. *Id.* § 1.1502-21A(f).

To assess Intermet's position, the consolidated return regulations direct us first to determine whether the group, as opposed to its individual members, satisfies the Code's requirements for the SLL carryback. *See* Treas. Reg. § 1.1502-80(a). We find that Intermet does satisfy these requirements. First, for purposes of this appeal, we will assume that Lynchburg's claimed expenses satisfy the definition of SL expenses under I.R.C. § 172(f)(1)(B) since the Tax Court did not decide this issue. Second, there is no dispute that the "taxpayer" — Intermet — had a CNOL in 1992. Third, Lynchburg's SL expenses were "taken into account" in calculating Intermet's CNOL because they directly affected Lynchburg's STI which, in turn, affected Intermet's CNOL. Indeed, Lynchburg's SL expenses reduced Lynchburg's STI and increased Intermet's CNOL dollar-for-dollar. Finally, Intermet was entitled to carry back the full amount of Lynchburg's SL expenses because those expenses did not exceed Intermet's CNOL for the year.

The IRS argues that Intermet does not satisfy the Code's requirements because it is improper to equate the Code's

references to "net operating loss" with Intermet's CNOL. We disagree. It is true that a group's CNOL is calculated somewhat differently than an individual corporation's NOL. But this is not dispositive. The consolidated return regulations tell us to apply the IRC provisions to "the group," and the CNOL represents the group's version of NOL. Moreover, the IRS has consistently taken the position — both in this case and otherwise — that the CNOL does have significance in applying the SLL carryback in the consolidated return context because only a group with a CNOL may take advantage of the carryback. *See* Tech. Adv. Mem. 9715002 (Apr. 11, 1997).

Having concluded that Intermet satisfies the statutory requirements for the SLL carryback, we next consider whether the consolidated return regulations somehow alter this result. *See* Treas. Reg. § 1.1502-80(a). Although the regulations do not explicitly address the SLL carryback, the IRS insists that the overall structure of those regulations preclude Intermet from taking advantage of the SLL carryback. Like the Tax Court, the IRS points out that the regulations require group members to deduct SL expenses in calculating their STI, since SL expenses do not appear on the list of "consolidated" items for purposes of calculating the group's taxable income. According to the IRS, in a case where the member incurring SL expenses also has a positive STI, the SL expenses "cannot give rise to any [CNOL] for the consolidated group, since those [expenses] are entirely absorbed by the income of the member before any consolidated item for the group is even computed." In other words, the IRS takes the position that Lynchburg's SL expenses were not "taken into account" in calculating

Intermet's CNOL because Lynchburg's positive STI "eliminated" the SL expenses. On the other hand, the IRS asserts that a member's SL expenses are taken into account in a CNOL if the member has a negative STI because the expenses are "not entirely absorbed at the member level."

While we agree with the IRS's overall description of the consolidated return regulations, we reject its analysis. A member's STI is simply a step along the way to calculating the group's taxable income or CNOL. An STI has no other purpose. More to the point, the regulations prescribing the calculation of STI and CNOL do not govern the determination of CNOL carrybacks. That issue is governed by Treas. Reg. § 1.1502-21A(b), which applies the carryback principles of section 172 to the consolidated NOL of the group, rather than separate member "NOLs" or STIs, in situations such as this one, which do not involve separate return years. In addition, the IRS and the Tax Court perceive a distinction between positive and negative STI that is unsupported by the regulations. An STI's character as positive or negative has no independent significance — either for purposes of calculating CNOL or otherwise. A member's SL expenses affect the group's CNOL dollar-for-dollar, and it makes no difference whether the member has a positive or negative STI. Because neither the purpose nor the language of the consolidated return regulations provide a basis for concluding that the member's SL expenses are "exhausted" when the member has a positive STI but remain when the member has a negative STI, we find that the IRS's interpretation is unreasonable.

Our conclusion is fortified by the IRS's history of adopting or applying differing interpretations of the SLL

carryback in the consolidated return context. Such inconsistency, while not determinative, is a factor we consider in assessing whether an agency interpretation of its regulations is "reasonable." *See Martin*, 499 U.S. at 157-58; *Martin*, 5 F.3d at 146. We have identified at least two inconsistencies that undermine the IRS's analysis.

First, in a 1997 Technical Advice Memorandum, the IRS adopted an interpretation of the consolidated return regulations that differs from its analysis in this case. Tech. Adv. Mem. 9715002 (Apr. 11 1997). The Memorandum addressed the precise issue presented here — *i.e.*, "[w]hether specified liability expenses incurred by a member of a consolidated group may be carried back when that member has positive taxable income for the year in which the expenses are incurred." *Id.* While the IRS answered that question in the negative, as it does in this case, it offered different reasoning. Specifically, the IRS reasoned that a group is entitled to the SLL carryback only to the extent that the SL expenses do not exceed the "portion of the [CNOL] attributable to a member" that incurred the SL expenses. *Id.* According to the IRS, the "portion of the [CNOL] attributable to a member" must be calculated under the formula prescribed by Treas. Reg. § 1.1502-79(a)(3) (as amended in 1996). *Id.*

Even if we assume the Memorandum is reconcilable with the IRS's position in this case because a portion of the CNOL cannot be attributed to a member with a positive STI under Treas. Reg. § 1.1502-79(a)(3), the Memorandum's reliance on this regulation is entirely misplaced. Section 1.1502-79(a) (redesignated as Treas. Reg. § 1.1502-79A(a) by T.D. 8677)

establishes a method for allocating CNOL to an individual member if a member seeks to carry back a loss to a "separate return year," *i.e.*, a year in which the member was not part of the consolidated group. The IRS contends that this allocation method may also apply in cases such as this one that involve carrybacks to a consolidated return year, pointing out that section 1.1502-79(a)(3) does not explicitly limit its application to separate return years. Tech. Adv. Mem. 9715002.

The IRS's interpretation ignores a "fundamental rule of statutory construction that statutory language is to be read in pertinent context rather than in isolation." *Oates v. Oates*, 866 F.2d 203, 206 (6th Cir. 1989). When reading section 1.1502-79A(a) as a whole, there is no question that it applies only to the separate return scenario. Section 1.1502-79A is entitled "separate return years"; subsection (a) is entitled "carryover and carryback of consolidated net operating losses to separate return years"; and subsection (a), including its illustrative examples, addresses only situations involving separate return years. Indeed, the IRS has recognized in the past that "although the [CNOL] is apportioned to individual members for purposes of carry backs to separate return years, the apportioned amounts are not separate NOLs of each member." 49 Fed. Reg. 30528, 30530 (1984) (preamble to Prop. Treas. Reg. § 1.1502-21(g)). We note that the Fourth Circuit recently held that a consolidated taxpayer is entitled to a "product liability loss" carryback — comparable to the SLL carryback — for that portion of an individual member's product liability expenses that does not exceed the member's "separate net operating loss" as calculated under section 1.1502-79A(a)(3). *United Dominion Indus., Inc. v. United*

States, __ F.3d __, 2000 WL 305134, at *8-9 (4th Cir. March 24, 2000). The court offered no analysis to support its conclusion that Treas. Reg. § 1.1502-79A(a)(3) dictates a method for calculating a member's "separate net operating loss" outside of the separate return context. *Id.* at *8, n.17. For the reasons outlined above, we are unpersuaded by the Fourth Circuit's approach.

A second inconsistency also arises out of the 1997 Technical Advice Memorandum. The IRS maintained in the Memorandum that Treas. Reg. § 1.1502-80, which applies the Code provisions to the group to the extent that the regulations do not exclude such application, actually supports its position. Tech. Adv. Mem. 9715002. The IRS reasoned that the Code's SLL provision applies on a separate member basis, rather than a consolidated basis, because the provision refers to "the taxpayer," and such language generally means individual members in the consolidated return context. *Id.* In contrast, the IRS in the instant cases ignores the section 1.1502-80 default rule. More importantly, the IRS has consistently and correctly referred to Intermet — not Lynchburg — as the "taxpayer" in this appeal.

We recognize that a Technical Advice Memorandum is not binding upon either the IRS or this court. *See* I.R.C. § 6110(j)(3) (1994). But the Memorandum illustrates the IRS's application of the SLL carryback in the consolidated return context — history that we may consider in determining whether the IRS's current position is reasonable. *See Wolpaw v. Commissioner*, 47 F.3d 787, 792 (6th Cir. 1995). We also understand that the IRS's basic position — that a consolidated group cannot invoke the SLL carryback if the

SL expenses are incurred by a member with a positive STI — has remained unchanged. However, the IRS's shifting and incongruous reasoning in reaching this result highlights the fundamental flaw: its position does not comport with the current purpose and language of the Code and regulations. It is trying to fit a square peg into a round hole.

We also reject the IRS's contention that Intermet will reap a "double tax benefit" if it uses SL expenses both to offset Lynchburg's positive STI and to extend the carryback period from three years to 10 years. Again, the IRS errs by attributing independent significance to the STI that does not exist. By offsetting part of Lynchburg's positive STI, the SL expenses produced no tax benefit whatsoever. Intermet — not Lynchburg — was the taxpayer for 1992. Intermet derived no tax benefit from the SL expenses in 1992 because Intermet had a CNOL exceeding $25 million and incurred no tax liability whatsoever in that year. Thus, the SL expense deductions produced only a single tax benefit — the ability to carry back those expenses to prior tax years.

In closing, we note the lack of any controlling judicial authority on the issue we decide here. Apart from the Fourth Circuit's recent opinion in *United Dominion*, which we have already discussed, the parties and the Tax Court identified two published opinions addressing arguably analogous issues: *Amtel, Inc. v. United States*, 31 Fed. Cl. 598 (1994), *aff'd*, 1995 WL 364366 (Fed. Cir. June 19, 1995) (unpublished disposition), and *Norwest Corp. and Subsidiaries v. Commissioner*, 111 T.C. 105 (1998). We find these cases to be distinguishable, however. Explicit statutory or regulatory provisions supported the separate member

approach that the courts adopted in *Amtel* and *Norwest*, rendering inapplicable the default rule in Treas. Reg. § 1.1502-80(a) that guides our analysis here. In summary, we conclude that the IRS's interpretation of the SLL carryback, in conjunction with the consolidated return regulations, is unreasonable. Intermet is entitled to the SLL carryback for Lynchburg's claimed SL expenses provided that those expenses qualify as a specified liability loss under I.R.C. § 172(f)(1)(B).

IV.

For the foregoing reasons, we **REVERSE** the judgment of the United States Tax Court and **REMAND** to that court for further proceedings consistent with this opinion.

APPENDIX F — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT DENYING PETITION FOR REHEARING IN *INTERMET CORPORATION & SUBSIDIARIES v. COMMISSIONER OF INTERNAL REVENUE* DATED AND FILED JUNE 1, 2000

Case No: 99-1046

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

ORDER

INTERMET CORPORATION & SUBSIDIARIES

Petitioner – Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent – Appellee

BEFORE: RYAN and SUHRHEINRICH, Circuit Judges; BELL, District Judge.*

Upon consideration of the petition for rehearing filed by the appellee,

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* The Honorable Robert Holmes Bell, United States District Judge for the Western District of Michigan, sitting by designation.

Appendix F

It is **ORDERED** that the petition for rehearing be, and it hereby is, **DENIED.**

ENTERED BY ORDER OF THE COURT

s/ Leonard Green
Leonard Green, Clerk